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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

(Amendment No. 2)

☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2005.**

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM ______ TO ______.**

Commission File Number: 0-23336

AROTECH CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**95-4302784**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1229 Oak Valley Drive, Ann Arbor, Michigan	**48108**
(Address of principal executive offices)	(Zip Code)

(800) 281-0356

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
None	Not applicable

Securities registered pursuant to Section 12(g) of the Act: **Common Stock, $0.01 par value**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes ☐ **No** ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act).
Yes ☐ **No** ☒

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: **Yes** ☒ **No** ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

Indicate by check mark whether the registrant is large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer: ☐ Accelerated filer: ☒ Non-accelerated filer: ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). **Yes** ☐ **No** ☒

The aggregate market value of the registrant's voting stock held by non-affiliates of the registrant as of June 30, 2005 was approximately $84,064,177 (based on the last sale price of such stock on such date as reported by The Nasdaq National Market and assuming, for the purpose of this calculation only, that all of the registrant's directors and executive officers are affiliates).

(Applicable only to corporate registrants) Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date: **8,468,957 as of 7/5/06**

Documents incorporated by reference: **None**

unless the form displays a currently valid OMB control number.

PRELIMINARY NOTE

Arotech Corporation is filing this Amendment No. 2 to its Annual Report on Form 10-K for the year ended December 31, 2005, as filed with the Securities and Exchange Commission on March 31, 2006, and as amended by Amendment No. 1 as filed with the Securities and Exchange Commission on June 16, 2006. The sole purpose of this amendment is to re-file the following document under Item 8, “Financial Statements and Supplementary Data,” which document was previously filed under Item 9A, “Controls and Procedures”:

- the report on internal control over financial reporting from Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global, Independent Registered Public Accounting Firm.

The foregoing documents does not contain any changes from the version of such document most recently filed with the Securities and Exchange Commission.

We are also filing a new version of our financial statements giving effect to a one-for-fourteen reverse stock split effected on June 21, 2006. As a result, we are filing the following documents under Item 8, “Financial Statements and Supplementary Data”:

- the report of Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global, Independent Registered Public Accounting Firm;

- the report of Stark Winter Schenkein & Co., LLP, Independent Registered Public Accounting Firm; and

- Arotech Corporation’s financial statements for the year ended December 31, 2005.

None of the foregoing documents contains any changes from the versions of such documents most recently filed with the Securities and Exchange Commission, except that the financial statements have been restated to give effect to a one-for-fourteen reverse stock split effected on June 21, 2006. Except in respect of the reverse stock split, the restated financial statements do not reflect the restatement of any previously reported financial statements, results of operations or any other related financial disclosures.

Additionally, as required by SEC regulations, we are:

- Providing additional Consents of Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global, and Stark Winter Schenkein & Co., LLP, Independent Registered Public Accounting Firms; and

- Replacing the Section 302 and Section 906 certifications from the Chairman and Chief Executive Officer and the Vice President – Finance and Chief Financial Officer.

PART II

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Index to Financial Statements

The financial statements have been restated to give effect to a one-for-fourteen reverse stock split effected on June 21, 2006.

Ernst & Young

■ Kost Forer Gabbay & Kasierer
3 Aminadav St.
Tel-Aviv 67067, Israel

■ Phone: 972-3-6232525
Fax: 972-3-5622555

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders of

AROTECH CORPORATION

We have audited the accompanying consolidated balance sheets of Arotech Corporation (the "Company") and its subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of operations, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2005. Our audits also included the financial statement schedule listed in Item 15(a)(2) of the Company's 10-K. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits. We did not audit the financial statements of "Armor of America Incorporated", a wholly-owned subsidiary of the Company, financial statements of which reflect total assets of 2.8% of the consolidated assets of the Company as of December 31, 2005, and total revenues of 8.8% of the consolidated revenues of the Company for the year then ended, or of "IES Interactive Training, Inc.", a wholly-owned subsidiary of the Company, financial statements of which reflect total assets of 3.5% of the consolidated assets of the Company as of December 31, 2005, and total revenues of 11.8% of the consolidated revenues of the Company for the year then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the data included for this subsidiary, is based solely on the report of the other auditors.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion based on our audits and the other auditors the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2005 and 2004, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles. Additionally, in our opinion the related financial statement schedule, when considered in relation to the basic financial statements and schedule taken as a whole, present fairly in all material respects the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated June 15, 2006 expressed an unqualified opinion on management's assessment of and an adverse opinion on the effectiveness of internal control over financial reporting.

/s/ Kost, Forer, Gabbay & Kasierer

KOST, FORER, GABBAY & KASIERER
A Member of Ernst & Young Global

Tel Aviv, Israel
March 30, 2006,
except for the final paragraph above,
as to which the date is June 15, 2006
and for Note 13.h.,
as to which the date
is July 24, 2006

ERNST & YOUNG

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of

AROTECH CORPORATION

We have audited management's assessment, included in the accompanying "Management's Report on Internal Control Over Financial Reporting," that Arotech Corporation ("Arotech" or "Company") did not maintain effective internal control over financial reporting as of December 31, 2005, because of the effect of the material weakness related to revenue recognition identified in management's assessment, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Arotech's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit. We did not examine the effectiveness of internal control over financial reporting of Armor of America Incorporated or IES Interactive Training Inc., wholly owned subsidiaries, whose financial statements in the aggregate reflect total assets and revenues constituting 6.3% and 20.6%, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 2005. The effectiveness of Armor of America Incorporated's and IES Interactive Training Inc.'s internal control over financial reporting was audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the effectiveness of Armor of America Incorporated's and IES Interactive Training Inc.'s internal control over financial reporting, is based solely on the reports of the other auditors.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit and the reports of the other auditors provide a reasonable basis for our opinion

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our report dated March 30, 2006, we disclaimed an opinion on management's assessment and on the effectiveness of the Company's internal control over financial reporting as of December 31, 2005, because management had not yet completed its assessment of the Company's internal control over financial reporting. Management has subsequently completed its assessment of internal control over financial reporting as of December 31, 2005. Accordingly, our present report on the effectiveness of the Company's internal control over financial reporting as of December 31, 2005, as presented herein, is different from our previous report dated March 30, 2006.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weakness has been identified and included in management's assessment: The Company did not maintain effective controls over the monitoring, review and approval of revenue recognition calculations at FAAC INC. Specifically, these calculations were not being reviewed by appropriate accounting personnel at FAAC INC. to determine that revenue is recognized in accordance with company policy and generally accepted accounting principles. This material weakness affects the Company's revenue and unbilled receivable accounts. This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 2005 financial statements, and this report does not affect our report dated March 30, 2006, except for the final paragraph of our report as to which the date is June 15, 2006, on those financial statements.

In our opinion, based on our audit and the reports of the other auditors, management's assessment that Arotech did not maintain effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the COSO control criteria. Also, in our opinion, based on our audit and the reports of the other auditors, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, Arotech has not maintained effective internal control over financial reporting as of December 31, 2005, based on the COSO control criteria.

/s/ Kost, Forer, Gabbay & Kasierer

KOST, FORER, GABBAY & KASIERER
A Member of Ernst & Young Global

Tel Aviv, Israel
June 15, 2006

STARK • WINTER • SCHENKEIN

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors
IES Interactive Training, Inc. and Subsidiary

We have audited the accompanying consolidated balance sheets of IES Interactive Training, Inc. and Subsidiary as of December 31, 2005, and the related consolidated statements of operations, stockholder's (deficit) and cash flows for the year ended December 31, 2005. We also have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that IES Interactive Training, Inc. and Subsidiary maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). IES Interactive Training, Inc. and Subsidiary's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these consolidated financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of IES Interactive Training, Inc. and Subsidiary as of December 31, 2005, and the results of its operations and its cash flows for the year ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, management's assessment that IES Interactive Training, Inc. and Subsidiary maintained effective internal control over financial reporting as of December 31, 2005 is fairly stated, in all material respects, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Furthermore, in our opinion, IES Interactive Training, Inc. and Subsidiary maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Stark Winter Schenkein & Co., LLP

Denver, Colorado
March 10, 2006

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Report of Independent Registered Public Accounting Firm

To the Shareholder
Armour of America, Inc.
Gardena, California

We have audited the accompanying balance sheet of Armour of America, Inc. as of December 31, 2005, and the related statements of operations, stockholder's equity and cash flows for the period August 11, 2004 to December 2004 and the year ended December 31, 2005. We also have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting , that Armour of America, Inc. maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Armour of America, Inc.'s management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Armour of America, Inc. as of December 31, 2005, and the related statements of operations, stockholder's equity and cash flows for the period August 11, 2004 to December 2004 and the year ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, management's assessment that Armour of America, Inc. maintained effective internal control over financial reporting as of December 31, 2005 is fairly stated, in all material respects, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Furthermore, in our opinion, Armour of America, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Stark Winter Schenkein & Co., LLP

Denver, Colorado
January 31, 2006

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

In U.S. dollars

	December 31,	
	2005	**2004**
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 6,150,652	$ 6,734,512
Restricted collateral deposits and restricted held-to-maturity securities	3,897,113	6,962,110
Available for sale marketable securities	35,984	135,568
Trade receivables (net of allowance for doubtful accounts in the amounts of $176,180 and $55,394 as of December 31, 2005 and 2004, respectively)	11,747,876	8,266,880
Unbilled receivables	5,228,504	2,881,468
Other accounts receivable and prepaid expenses	2,264,331	1,339,393
Inventories	7,815,806	7,277,301
Total current assets	37,140,266	33,597,232
SEVERANCE PAY FUND	2,072,034	1,980,047
RESTRICTED DEPOSITS	779,286	4,000,000
PROPERTY AND EQUIPMENT, NET	4,252,931	4,600,691
INVESTMENT IN AFFILIATED COMPANY	37,500	—
OTHER INTANGIBLE ASSETS, NET	11,027,499	14,368,701
GOODWILL	29,559,157	39,745,516
	$ 84,868,673	$ 98,292,187

The accompanying notes are an integral part of the consolidated financial statements.

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

In U.S. dollars

	December 31, 2005	December 31, 2004
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	$ 5,830,820	$ 6,177,546
Other accounts payable and accrued expenses	5,630,108	5,818,188
Current portion of promissory notes due to purchase of subsidiaries	603,764	13,585,325
Short term bank credit and current portion of long term loans	2,036,977	181,352
Deferred revenues	603,022	618,229
Convertible debenture	11,492,238	—
Liabilities of discontinued operations	120,000	—
Total current liabilities	26,316,929	26,380,640
LONG TERM LIABILITIES		
Accrued severance pay	3,657,328	3,422,951
Convertible debenture	8,590,233	1,754,803
Deferred revenues	—	163,781
Long term loan	—	20,891
Long-term portion of promissory note due to purchase of subsidiaries	—	980,296
Total long-term liabilities	12,247,561	6,342,722
COMMITMENTS AND CONTINGENT LIABILITIES (Note 11)		
MINORITY INTEREST	38,927	95,842
STOCKHOLDERS' EQUITY:		
Share capital -		
Common stock - $0.01 par value each;		
Authorized: 250,000,000 shares as of December 31, 2004 and 2003; Issued: 6,221,194 shares and 5,759,786 shares as of December 31, 2005 and 2004, respectively; Outstanding - 6,181,527 shares and 5,720,119 shares as of December 31, 2005 and 2004, respectively	870,969	806,370
Preferred shares - $0.01 par value each;		
Authorized: 1,000,000 shares as of December 31, 2005 and 2004; No shares issued and outstanding as of December 31, 2005 and 2004	—	—
Additional paid-in capital	193,949,882	189,266,103
Accumulated deficit	(142,996,964)	(118,953,553)
Deferred stock compensation	(389,303)	(1,258,295)
Treasury stock, at cost (common stock - 39,667 shares as of December 31, 2005 and 2004)	(3,537,106)	(3,537,106)
Notes receivable from stockholders	(1,256,777)	(1,222,871)
Accumulated other comprehensive income	(375,445)	372,335
Total stockholders' equity	46,265,256	65,472,983
	$ 84,868,673	$ 98,292,187

The accompanying notes are an integral part of the consolidated financial statements.

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

In U.S. dollars

	Year ended December 31,		
	2005	**2004**	**2003**
Revenues	$ 49,044,595	$ 49,953,846	$ 17,326,641
Cost of revenues	34,383,736	34,011,094	11,087,840
Gross profit	14,660,859	15,942,752	6,238,801
Operating expenses:			
Research and development, net	1,300,429	1,731,379	1,053,408
Selling and marketing expenses	4,471,590	4,922,217	3,532,636
General and administrative expenses	14,862,435	10,656,866	5,857,876
Amortization of intangible assets	3,070,748	2,494,556	864,910
Impairment of goodwill and other intangible assets	12,256,756	320,279	—
Total operating costs and expenses	35,961,958	20,125,297	11,308,830
Operating loss	(21,301,099)	(4,182,545)	(5,070,029)
Other income	338,900	—	—
Financial income (expenses), net	(2,705,689)	(4,228,965)	(4,038,709)
Loss before minorities interests in loss (earnings) of a subsidiaries and tax expenses	(23,667,888)	(8,411,510)	(9,108,738)
Income taxes	(237,672)	(586,109)	(396,193)
Loss from affiliated company	(75,000)	—	—
Minorities interests in loss (earnings) of a subsidiaries	57,149	(44,694)	156,900
Loss from continuing operations	(23,923,411)	(9,042,313)	(9,348,031)
Income (loss) from discontinued operations	(120,000)	—	110,410
Net loss	$ (24,043,411)	$ (9,042,313)	$ (9,237,621)
Deemed dividend to certain stockholders	$ —	$ (3,328,952)	$ (350,000)
Net loss attributable to common stockholders	$ (24,043,411)	$ (12,371,265)	$ (9,587,621)
Basic and diluted net loss per share from continuing operations	$ (4.07)	$ (1.81)	$ (3.37)
Basic and diluted net loss per share from discontinued operations	$ (0.02)	$ 0.00	$ (0.04)
Basic and diluted net loss per share	$ (4.09)	$ (2.48)	$ (3.45)
Weighted average number of shares used in computing basic and diluted net loss per share	5,872,093	4,995,218	2,777,870

The accompanying notes are an integral part of the consolidated financial statements.

AROTECH CORPORATION AND ITS SUBSIDIARIES
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

In U.S. dollars

	Common stock									
	Shares	Amount	Additional paid-in capital	Accumulated deficit	Deferred stock compensation	Treasury stock	Notes receivable from stockholders	Accumulated other comprehensive loss	Total comprehensive income (loss)	Total stockholders' equity
Balance as of January 1, 2003	2,550,115	$ 357,017	$ 114,082,584	$ (100,673,619)	$ (12,000)	$ (3,537,106)	$ (1,177,589)	$ (1,786)		$ 9,037,501
Compensation related to warrants issued to the holders of convertible debentures			5,157,500							5,157,500
Compensation related to beneficial conversion feature of convertible debentures			5,695,543							5,695,543
Issuance of shares on conversion of convertible debentures	497,829	69,696	6,064,981				(9,677)			6,125,000
Issuance of shares on exercise of warrants	263,071	36,831	3,259,422							3,296,253
Issuance of shares to consultants	15,971	2,236	159,711							161,947
Compensation related to grant and reprcing of warrants and options issued to consultants			229,259							229,259
Compensation related to non-recourse loan granted to shareholder			38,500							38,500
Deferred stock compensation			4,750		(4,750)					—
Amortization of deferred stock compensation					8,286					8,286
Exercise of options by employees	49,260	6,896	426,668							433,564
Exercise of options by consultants	1,071	150	7,200							7,350
Conversion of convertible promissory note	40,284	5,640	438,720							444,360
Increase in investment in subsidiary against common stock issuance	9,000	1,260	120,960							122,220
Accrued interest on notes receivable from stockholders			16,615				(16,615)			—
Other comprehensive income - foreign currency translation adjustment								106,215	$ 106,215	106,215
Net loss				(9,237,621)					(9,237,621)	(9,237,621)
									$ (9,131,406)	
Balance as of December 31, 2003	3,426,601	$ 479,726	$ 135,702,413	$ (109,911,240)	$ (8,464)	$ (3,537,106)	$ (1,203,881)	$ 104,429		$ 21,625,877

The accompanying notes are an integral part of the consolidated financial statements.

AROTECH CORPORATION AND ITS SUBSIDIARIES
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

In U.S. dollars

	Common stock									
	Shares	Amount	Additional paid-in capital	Accumulated deficit	Deferred stock compensation	Treasury stock	Notes receivable from stockholders	Accumulated other comprehensive loss	Total comprehensive income	Total stockholders' equity
Balance as of January 1, 2004	3,426,601	$ 479,726	$ 135,702,413	$ (109,911,240)	$ (8,464)	$ (3,537,106)	$ (1,203,881)	$ 104,429		$ 21,625,877
Issuance of shares, net	1,009,892	141,384	24,252,939							24,394,323
Issuance of shares and warrants due to settlement of litigation	32,143	4,500	1,244,328							1,248,828
Issuance of shares to employees	2,857	400	92,800							93,200
Conversion of convertible debentures	274,552	38,437	3,754,279							3,792,716
Exercise of warrants by investors and others	811,667	113,633	19,119,638							19,233,271
Issuance of shares to consultants	6,444	902	198,489							199,391
Reclassification to liability in connection with warrants granted			(10,841,020)							(10,841,020)
Reclassification of liability to equity related to the fair value of warrants			10,514,181							10,514,181
Compensation related to non-recourse loan granted to shareholder			(10,000)							(10,000)
Deferred stock compensation related to options and restricted stock	52,857	7,400	2,074,057		(2,081,457)					—
Amortization of deferred stock compensation					831,626					831,626
Exercise of options by employees	64,089	8,972	1,101,172							1,110,144
Exercise of options by consultants	2,687	376	50,799							51,175
Issuance of shares in respect of FAAC acquisition	71,704	10,039	1,993,639							2,003,678
Accrued interest on notes receivable from stockholders			18,990				(18,990)			—
Other comprehensive income - foreign currency translation adjustment								263,404	$ 263,404	263,404
Other comprehensive income - realized gain on available for sale marketable securities								4,502	4,502	4,502
Net loss				(9,042,313)					(9,042,313)	(9,042,313)
									$ (8,774,407)	
Balance as of December 31, 2004	5,755,493	$ 805,769	$ 189,266,704	$ (118,953,553)	$ (1,258,295)	$ (3,537,106)	$ (1,222,871)	$ 372,335		$ 65,472,983

The accompanying notes are an integral part of the consolidated financial statements.

AROTECH CORPORATION AND ITS SUBSIDIARIES
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

In U.S. dollars

	Common stock									
	Shares	**Amount**	**Additional paid-in capital**	**Accumulated deficit**	**Deferred stock compensation**	**Treasury stock**	**Notes receivable from stockholders**	**Accumulated other comprehensive income (loss)**	**Total comprehensive income (loss)**	**Total stockholders' equity**
Balance as of January 1, 2005	5,759,786	$ 806,370	$ 189,266,103	$ (118,953,553)	$ (1,258,295)	$ (3,537,106)	$ (1,222,871)	$ 372,335		$ $65,472,983
Issuance of shares, net	339,640	47,551	3,898,185							3,945,736
Shares issued to convertible debenture holders	82,976	11,617	441,434							453,051
Shares issued to consultant	36,232	5,073	516,200							521,273
Compensation related to non-recourse loan granted to shareholder			(28,500)							(28,500)
Employee options exercise	1,132	158	17,034							17,192
Shares issued to employees	714	100	(100)							—
Deferred stock compensation related to options and restricted stock	3,571	500	50,500		(51,000)					—
Amortization of deferred stock compensation					674,712					674,712
Cancellation of deferred stock compensation as a result of forfeitures	(2,857)	(400)	(244,880)		245,280					—
Interest accrued on notes receivable from shareholders			33,906				(33,906)			—
Other comprehensive loss - foreign currency translation adjustment								(746,016)	(746,016)	(746,016)
Other comprehensive loss - unrealized gain on available for sale marketable securities								(1,764)	(1,764)	(1,764)
Net loss				(24,043,411)					(24,043,411)	(24,043,411)
Total comprehensive loss									$ (24,791,191)	
Balance as of December 31, 2005	6,221,194	$ 870,969	$ 193,949,882	$ (142,996,964)	$ (389,303)	$ (3,537,106)	$ (1,256,777)	$ (375,445)		$ 46,265,256

The accompanying notes are an integral part of the consolidated financial statements.

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

In U.S. dollars

	Year ended December 31, 2005	2004	2003
Cash flows from operating activities:			
Net loss	$ (24,043,411)	$ (9,042,313)	$ (9,237,621)
Less loss (profit) for the period from discontinued operations	120,000	—	(110,410)
Adjustments required to reconcile net loss to net cash used in operating activities:			
Minorities interests in earnings (loss) of subsidiary	(57,149)	44,694	(156,900)
Loss from affiliated company	75,000	—	—
Depreciation	1,373,580	1,199,465	730,159
Amortization of intangible assets, capitalized software costs and impairment of intangible assets	15,453,584	2,888,226	879,311
Remeasurement of liability in connection to warrants granted	(377,803)	(326,839)	—
Accrued severance pay, net	68,839	(441,610)	3,693
Amortization of deferred stock compensation and compensation related to shares issued to employees	674,713	884,826	8,286
Mark up of loans to stockholders	—	(32,397)	(12,519)
Write-off of inventories	1,062,336	121,322	96,350
Impairment of property and equipment	34,243	—	68,945
Amortization of compensation related to warrants issued to the holders of convertible debentures and beneficial conversion feature	1,702,753	4,142,109	3,928,237
Amortization of deferred charges related to convertible debentures issuance	329,152	222,732	483,713
Amortization of prepaid financial expenses	—	—	236,250
Stock-based compensation related to grant of new warrants and repricing of warrants granted to consultants	—	—	229,259
Stock-based compensation related to shares issued and to be issued to consultants and shares granted as a donation	538,058	89,078	161,947
Stock-based compensation related to non-recourse note granted to stockholder	(28,500)	(10,000)	38,500
Interest accrued or paid on promissory notes due to acquisition	19,704	39,311	(66,793)
Interest accrued on restricted collateral deposits	—	(267,179)	—
Capital loss (gain) from sale of marketable securities	2,695	(4,247)	—
Amortization of premium related to restricted held to maturity securities	42,234	202,467	—
Capital loss (gain) from sale of property and equipment	3,172	(16,479)	(11,504)
Decrease (increase) in trade receivables	(3,608,950)	732,828	(820,137)
Decrease (increase) in other accounts receivable and prepaid expenses	(75,982)	(49,513)	40,520
Decrease (increase) in deferred tax assets	65,376	(89,823)	—
Increase in inventories	(1,710,528)	(2,040,854)	(193,222)
Increase in unbilled revenues	(2,347,036)	(1,581,080)	—
Decrease in deferred revenues	(178,988)	(91,271)	—
Increase (decrease) in trade payables	(224,987)	2,913,623	(986,022)
Increase (decrease) in other accounts payable and accrued expenses	32,269	(125,231)	1,677,668
Net cash used in operating activities from continuing operations	(11,055,626)	(638,155)	(3,012,290)
Net cash used in operating activities from discontinued operations	—	(214,041)	(313,454)
Net cash used in operating activities	$ (11,055,626)	$ (852,196)	$ (3,325,744)

The accompanying notes are an integral part of the consolidated financial statements.

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

In U.S. dollars

	Year ended December 31,		
	2005	**2004**	**2003**
Cash flows from investing activities:			
Purchase of property and equipment	(1,224,752)	(1,659,688)	(580,949)
Increase in capitalized software costs	(651,611)	(365,350)	(209,616)
Loans granted to stockholders	—	(1,036)	(13,737)
Repayment of loans granted to stockholders	—	32,397	9,280
Proceeds from sale of property and equipment	104,175	114,275	16,753
Proceeds from sale of marketable securities	91,936	90,016	—
Investment in marketable securities	—	(89,204)	—
Investment in affiliated company	(112,500)	—	—
Payment of transaction expenses in relation to previous year investment in subsidiary	(12,945)	—	—
Acquisition of Epsilor (1)	—	(7,190,777)	—
Acquisition of FAAC (2)	—	(12,129,103)	—
Acquisition of AoA (3)	—	(17,339,522)	—
Repayment of promissory notes related to acquisition of subsidiaries (1)(2)	(14,588,298)	(2,000,000)	(750,000)
Purchase of certain tangible and intangible assets	(150,000)	(150,000)	(196,331)
Increase in restricted cash and held to maturity securities	4,748,178	(9,809,091)	(72,840)
Net cash used in investing activities	(11,795,817)	(50,497,083)	(1,797,440)
Cash flows from financing activities:			
Proceeds from issuance of shares, net	3,945,736	24,361,750	(6,900)
Proceeds from exercise of options to employees and consultants	17,192	1,148,819	440,914
Proceeds from exercise of warrants	—	19,233,271	3,296,254
Proceeds from issuance of convertible debentures, net of issuance expenses	16,430,767	—	13,708,662
Long term loan received	—	69,638	—
Repayment of long term loan	(71,238)	(65,674)	—
Increase (decrease) in short term bank credit	1,914,892	(376,783)	(74,158)
Payment on capital lease obligation	—	(4,145)	(4,427)
Net cash provided by financing activities	22,237,349	44,366,876	17,360,345
Increase (decrease) in cash and cash equivalents	(614,094)	(6,982,403)	12,237,161
Cash erosion due to exchange rate differences	30,234	31,790	(9,562)
Cash and cash equivalents at the beginning of the year	6,734,512	13,685,125	1,457,526
Cash and cash equivalents at the end of the year	$ 6,150,652	$ 6,734,512	$ 13,685,125
Supplementary information on non-cash transactions:			
Issuance of shares and warrants against accrued expenses and restricted deposit	$ 56,577	$ 1,310,394	$ —
Purchase of intangible assets against note receivable	$ —	$ —	$ 300,000
Increase of investment in subsidiary against issuance of shares of common stock	$ —	$ —	$ 123,480
Conversion of promissory note to shares of common stock	$ —	$ —	$ 450,000
Payment of principle installment of convertible debenture in shares	$ 453,051	$ —	$ —
Liability in connection to warrants granted	$ 44,231	$ —	$ —
Conversion of convertible debenture to shares of common stock	$ —	$ 3,837,500	$ 6,125,000
Benefit due to convertible debentures and warrants	$ —	$ —	$ 10,853,043
Accrual for earn out in regard to subsidiary acquisition	$ 603,764	$ 13,435,325	$ —
Supplemental disclosure of cash flows activities:			
Cash paid during the year for:			
Interest	$ 1,401,681	$ 532,750	$ 39,412
Taxes on income	$ 737,080	$ 969,009	$ 527,053

The accompanying notes are an integral part of the consolidated financial statements.

In U.S. dollars

(1) In January 2004, the Company acquired substantially all of the outstanding ordinary shares of Epsilor Electronic Industries, Ltd. ("Epsilor"). The net fair value of the assets acquired and the liabilities assumed, at the date of acquisition, was as follows:

Working capital, excluding cash and cash equivalents	$ (849,992)
Property and equipment	709,847
Intangible assets and goodwill	10,284,407
	10,144,262
Issuance of shares in respect to transaction costs	(12,500)
Issuance of promissory note *)	(2,940,985)
	$ 7,190,777

*) During 2005 and 2004 amounts of $1,000,000 and $2,000,000, respectively, were repaid to the former shareholders of Epsilor.

(2) In January 2004, the Company acquired all of the outstanding common stock of FAAC Incorporated ("FAAC"). The net fair value of the assets acquired and the liabilities assumed at the date of acquisition was as follows:

Working capital, excluding cash and cash equivalents	$ 1,796,791
Property and equipment	263,669
Intangible assets and goodwill	12,072,321
	14,132,781
Issuance of shares, net	(2,003,678)
	$ 12,129,103

*) During 2005, an additional amount of $13,588,298 was paid to the former shareholders of FAAC in respect of the earnout provisions of the acquisition agreement. The additional amount was charged to goodwill.

(3) In August 2004, the Company acquired all of the outstanding common stock of Armour of America, Incorporated ("AoA"). The net fair value of the assets acquired and the liabilities assumed at the date of acquisition was as follows:

Working capital, excluding cash and cash equivalents	$ 3,219,728
Property and equipment	997,148
Intangible assets and goodwill	13,122,646
	$ 17,339,522

See note 1.d. regarding additional earnout obligation to the former shareholder of AoA.

The accompanying notes are an integral part of the consolidated financial statements.

In U.S. dollars

NOTE 1:– GENERAL

a. Arotech Corporation ("Arotech" or the "Company") and its subsidiaries are engaged in the development, manufacture and marketing of defense and security products, including advanced high-tech multimedia and interactive digital solutions for training of military, law enforcement and security personnel and sophisticated lightweight materials and advanced engineering processes to armor vehicles, and in the design, development and commercialization of its proprietary zinc-air battery technology for electric vehicles and defense applications. The Company is primarily operating through IES Interactive Training, Inc. ("IES"), a wholly-owned subsidiary based in Littleton, Colorado; FAAC Corporation, a wholly-owned subsidiary based in Ann Arbor, Michigan, and FAAC's 80%-owned United Kingdom subsidiary FAAC Limited; Electric Fuel Battery Corporation, a wholly-owned subsidiary based in Auburn, Alabama; Electric Fuel Ltd. ("EFL") a wholly-owned subsidiary based in Beit Shemesh, Israel; Epsilor Electronic Industries, Ltd., a wholly-owned subsidiary located in Dimona, Israel; MDT Protective Industries, Ltd. ("MDT"), a majority-owned subsidiary based in Lod, Israel; MDT Armor Corporation, a majority-owned subsidiary based in Auburn, Alabama; and Armour of America, Incorporated, a wholly-owned subsidiary based in Los Angeles, California.

Revenues derived from the Company's largest customers in 2005, 2004 and 2003 are described in Note 16.d.

b. Acquisition of Epsilor:

In January 2004, the Company entered into a stock purchase agreement between itself and all of the shareholders of Epsilor Electronic Industries, Ltd. ("Epsilor"), pursuant to the terms of which the Company purchased all of the outstanding shares of Epsilor from Epsilor's existing shareholders. Epsilor develops and sells rechargeable and primary lithium batteries and smart chargers to the military, and to private industry in the Middle East, Europe and Asia.

The Acquisition was accounted under the purchase method accounting. Accordingly, all assets and liabilities acquired were recorded at their estimated market values as of the date of acquisition, and results of Epsilor's operations have been included in the consolidated financial statements commencing the date of acquisition. The total consideration of $10,144,262 (including transaction costs) for the shares purchased consisted of (i) cash in the amount of $7,000,000, and (ii) a series of three $1,000,000 promissory notes, due on the first, second and third anniversaries of the agreement, which were recorded at their fair value of $2,940,985.

Based upon a valuation of tangible and intangible assets acquired, Arotech has allocated the total cost of the acquisition to Epsilor's net assets as follows:

Tangible assets acquired	$ 2,239,848
Intangible assets	
Customer list	5,092,395
Goodwill	5,192,012
Liabilities assumed	(2,379,993)
Total consideration	$ 10,144,262

In U.S. dollars

NOTE 1:– GENERAL (Cont.)

Customer list in the amount of $5,092,395 has a useful life of approximately ten years.

In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," goodwill arising from acquisitions will not be amortized. In lieu of amortization, Arotech is required to perform an annual impairment test. If Arotech determines, through the impairment review process, that goodwill has been impaired, it will record the impairment charge in its statement of operations. Arotech will also assess the impairment of goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

The value assigned to tangible, intangible assets and liabilities was determined as follows:

1. To determine the estimated market value of Epsilor's net current assets, property and equipment, and net liabilities, the "Cost Approach" was used. According to the valuation made, the book values for the current assets and liabilities were reasonable proxies for their market values.

2. The customer list is the asset that generates most of the Company's sales. Hence, the "Income Approach" was used to estimate its value, resulting in a value of $5,092,395.

See Note 1.e. for pro forma financial information.

c. Acquisition of FAAC:

In January of 2004, the Company entered into a stock purchase agreement with the stockholders of FAAC Incorporated ("FAAC"), pursuant to the terms of which it acquired all of the issued and outstanding common stock of FAAC, a provider of driving simulators, systems engineering and software products to the United States military, government and private industry.

The Acquisition was accounted under the purchase method accounting. Accordingly, all assets and liabilities were recorded at their estimated market values as of the date acquired, and results of FAAC's operations have been included in the consolidated financial statements commencing the date of acquisition. The consideration for the purchase consisted of (i) cash in the amount of $12.0 million, and (ii) the issuance of a total of 71,704 shares of the Company's common stock, $0.14 par value per share, having a value of approximately $2.0 million. There was also an earn-out based on 2004 net pretax income. Based on FAAC's 2004 net pretax income, the Company paid the former stockholders of FAAC an earnout of $13.6 million during 2005, in cash and through the issuance of a total of 3,479,465 shares of the Company's common stock (see Note 13.b.5.). The total consideration of $27.7 million (including the earn-out as well as $137,991 of transaction costs) was determined based upon arm's-length negotiations between the Company and FAAC's stockholders.

In addition, the Company has a contingent earnout obligation in an amount equal to the net income realized by the Company from certain specific programs that were identified by the Company and the former shareholders of FAAC as appropriate targets for revenue increases in 2005. During 2005, the Company accrued an amount of $603,764 in respect of such earnout obligation against FAAC's goodwill. Although the former shareholders of FAAC have indicated to the Company their belief that the specific programs identified include more orders than those with respect to which the Company has made accrual in respect of this earnout obligation, the Company believes there is no basis for this claim (see note 11.e.3.).

In U.S. dollars

NOTE 1:– GENERAL (Cont.)

Based upon a valuation of tangible and intangible assets acquired, Arotech has allocated the total cost of the acquisition (including earnout obligation accrued as of December 31, 2005) to FAAC's assets and liabilities as follows:

Tangible assets acquired	$ 4,833,553
Intangible assets	
Technology	4,610,000
Backlog	636,000
Customer list	1,125,000
Trademarks	374,000
Goodwill	19,522,343
Liabilities assumed	(2,770,843)
Total consideration	$28,330,053

Intangible assets which are subject to amortization, excluding trademarks, which are not subject to amortization, in the amount of $6,371,000 have a weighted-average useful life of approximately eight years.

In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," goodwill arising from acquisitions will not be amortized. In lieu of amortization, Arotech is required to perform an annual impairment test. If Arotech determines, through the impairment review process, that goodwill has been impaired, it will record the impairment charge in its statement of operations. Arotech will also assess the impairment of goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

The value assigned to tangible, intangibles assets and liabilities was determined as follows:

1. To determine the estimated fair value of FAAC's net current assets, property and equipment, and net liabilities, the "Cost Approach" was used. According to the valuation made, the book values for the current assets and liabilities were reasonable proxies for their market values.

2. The amount of the cost attributable to technology of the software, documentation and know-how that drives the vehicle simulators and the high-speed missile fly-out simulators is $4,610,000 and was determined using the "Income Approach."

3. FAAC's sales are all made on a contractual basis, most of which are over a relatively long period of time. At the date of the purchase FAAC had several signed contracts at various stages of completion. The value of the existing contracts was determined using the Income approach and resulting in a value of $636,000.

In U.S. dollars

NOTE 1:– GENERAL (Cont.)

4. FAAC's customer list includes various branches of the U.S. military, major defense contractors, various city and country governments and others. Since customer relationship represent one of the most important revenue generating assets for FAAC, its value was estimated using the Income Approach, resulting in a value of $1,125,000.

5. FAAC's trade name value represents the name recognition value of the FAAC brand name as a result of advertising spending by the company. The Cost Approach was used to determine the value of FAAC's trade name in the amount of $374,000.

See Note 1.e. for pro forma financial information.

d. Acquisition of AoA:

In August 2004, the Company purchased all of the outstanding stock of Armour of America, Incorporated, a California corporation ("AoA"), from AoA's existing shareholder. The assets acquired through the purchase of all of AoA's outstanding stock consisted of all of AoA's assets, including AoA's current as-sets, property and equipment, and other assets (including intangible assets such as in-tellectual property and contractual rights).

The total purchase price consisted of $19,000,000 in cash, with additional possible earn-outs if AoA is awarded certain material contracts. An additional $3,000,000 was to be paid into an escrow account pursuant to the terms of an escrow agreement, to secure a portion of the Earnout Consideration. These funds are currently being held by the seller of AoA. Pursuant to the purchase agreement, the total consideration, sale price plus Earnout Consideration, will not be in excess of $40,000,000. When the contingency on the earn-out provision is resolved, the additional consideration, if any, will be recorded as additional purchase price. The purchase price also included $131,177 of transaction costs. The transaction has been accounted for using the purchase method of accounting, and accordingly, the purchase price has been allocated to the assets acquired and liabilities assumed based upon their fair values at the date the acquisition was completed.

In U.S. dollars

NOTE 1:– GENERAL (Cont.)

Based upon a valuation of tangible and intangible assets acquired, Arotech has allocated the total cost of the acquisition (including earnout obligation accrued as of December 31, 2005), to AoA's assets and liabilities as follows :

Tangible assets acquired	6,346,316
Intangible assets	
Certifications	246,969
Backlog	1,512,000
Customer relationships	490,000
Tradename /Trademark	70,000
Covenants not to compete	260,000
Goodwill	11,757,812
Liabilities assumed	(347,770)
Total consideration	$20,335,327

Intangible assets, excluding trademarks, which are not subject to amortization, in the amount of $2,508,969 have a weighted-average useful life of approximately two years.

In connection with the Company's acquisition of AoA, the Company has a contingent earnout obligation in an amount equal to the revenues realized by the Company from certain specific programs that were identified by the Company and the former shareholder of AoA as appropriate targets for revenue increases. The earnout provides that if AoA receives certain types of orders from certain specific customers prior to December 31, 2006 ("Additional Orders"), then upon shipment of goods in connection with such Additional Orders, the former shareholder of AoA will be paid an earnout based on revenues, up to a maximum of an additional $6 million. During 2005, the Company accrued an amount of $1,204,150 in respect of such earnout obligation.

In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," goodwill arising from acquisitions will not be amortized. In lieu of amortization, Arotech is required to perform an annual impairment test. If Arotech determines, through the impairment review process, that goodwill has been impaired, it will record the impairment charge in its statement of operations. Arotech will also assess the impairment of goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

See Note 1.f. for impairment information.

See Note 1.e. for pro forma financial information.

e. Pro forma results

In January 2004, the Company acquired FAAC and Epsilor, as more fully described in "Note 1.b. - Acquisition of Epsilor" and "Note 1.c. - Acquisition of FAAC," above, in August 2004, the Company acquired AoA, as more fully described in "Note 1.d. - Acquisition of AoA," above (the "Acquisitions"). The following summary pro forma information includes the effects of the Acquisitions on the operating results of the Company. The following unaudited pro forma data for 2004 and 2003 are presented as if the Acquisitions had been completed on January 1, 2004 and 2003, respectively.

In U.S. dollars

NOTE 1:– GENERAL (Cont.)

This pro forma financial information does not purport to be indicative of the results of operations that would have occurred had the Acquisitions taken place at the beginning of the period, nor do they purport to be indicative of the results of operations that will be obtained in the future.

	Year Ended December 31,	
	2004	**2003**
	(Unaudited)	
Total revenues	$ 61,086,697	$ 39,680,394
Gross profit	22,528,254	17,214,249
Net loss	(5,810,114)	(6,959,174)
Deemed dividend of common stock attributable to certain stockholders	(3,328,952)	(350,000)
Net loss attributable to stockholders of common stock	$ (9,139,066)	$ (7,309,174)
Basic and diluted net loss per share	$ (1.83)	$ (1.93)
Weighted average number of shares used in computing basic net loss per share	4,995,218	3,783,309

f. Impairment of goodwill and other intangible assets:

SFAS No. 142 requires goodwill to be tested for impairment on adoption of the Statement, at least annually thereafter, and between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of the Company's reportable units with their carrying value. Fair value is determined using discounted cash flows. Significant estimates used in the methodologies include estimates of future cash flows, future short-term and long-term growth rates, weighted average cost of capital and estimates of market multiples for the reportable units.

During 2005, the Company performed impairment test of goodwill, based on management's projections and using expected future discounted operating cash flows and as response to several factors, including without limitation the reduced sales in AoA (a component of the Company's Armor Division) the fact that AoA failed to meet its projections, the decision of the General Manager of AoA and his new supervisor to leave the employ of AoA and the Company, respectively, and general uncertainty about the market for AoA's products in general and AoA's business in particular; specifically, the delay or loss of several potential orders, decisions by customers to utilize methods of armor not produced by AoA (hard armor instead of soft armor), the change in U.S. military priorities from acquiring new armor to funding the ground forces in Iraq and Afghanistan. Furthermore, following Hurricane Katrina, substantial funds earmarked for defense were delayed to provide funds for hurricane relief. As of December 31, 2005, as a result of this impairment test, the Company identified in AoA an impairment of goodwill in the amount of $11,757,812.

In U.S. dollars

NOTE 1:– GENERAL (Cont.)

The Company and its subsidiaries' long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with Statement of Financial Accounting Standard No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"), whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the carrying amount of assets to be held and used is measured by a comparison of the carrying amount of the assets to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. As of December 31, 2004 the Company identified an impairment of the technology previously purchased from Bristlecone and as a result has recorded an impairment loss in the amount of $320,279. As of December 31, 2005 the Company identified an impairment of backlog, trademarks and a covenant not to compete previously identified with respect to the AoA acquisition and as a result recorded an impairment loss in the amount of $498,944.

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States ("U.S. GAAP").

a. Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

b. Financial statements in U.S. dollars:

A majority of the revenues of the Company and most of its subsidiaries and its subsidiaries' affiliates is generated in U.S. dollars. In addition, a substantial portion of the Company's and most of its subsidiaries costs are incurred in U.S. dollars ("dollar"). Management believes that the dollar is the primary currency of the economic environment in which the Company and most of its subsidiaries operate. Thus, the functional and reporting currency of the Company and most of its subsidiaries is the dollar. Accordingly, monetary accounts maintained in currencies other than the U.S. dollar are remeasured into U.S. dollars in accordance with Statement of Financial Accounting Standards No. 52 "Foreign Currency Translation" ("SFAS No. 52"). All transaction, gains and losses from the remeasured monetary balance sheet items are reflected in the consolidated statements of operations as financial income or expenses, as appropriate.

The majority of transactions of MDT and Epsilor are in New Israel Shekels ("NIS") and a substantial portion of MDT's and Epsilor's costs is incurred in NIS. Management believes that the NIS is the functional currency of MDT and Epsilor. Accordingly, the financial statements of MDT and Epsilor have been translated into U.S. dollars. All balance sheet accounts have been translated using the exchange rates in effect at the balance sheet date. Statement of operations amounts has been translated using the weighted average exchange rate for the period. The resulting translation adjustments are reported as a component of accumulated other comprehensive loss in stockholders' equity

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its wholly and majority owned subsidiaries. Intercompany balances and transactions have been eliminated upon consolidation.

d. Cash equivalents:

Cash equivalents are short-term highly liquid investments that are readily convertible to cash with maturities of three months or less when acquired.

e. Restricted collateral deposits

Restricted cash is primarily invested in highly liquid deposits which are used as a security for the Company's guarantee performance, its liability to a former shareholder of its acquired subsidiary and for the company's liability for interest payments related to its convertible debentures.

f. Marketable securities

The Company and its subsidiaries account for investments in debt and equity securities in accordance with Statement of Financial Accounting Standard No. 115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS No. 115"). Management determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date.

At December 31, 2005 the Company and its subsidiaries classified its investment in marketable securities as available-for-sale.

Investment in trust funds are classified as available-for-sale and stated at fair value, with unrealized gains and losses reported in accumulated other comprehensive income (loss), a separate component of stockholders' equity, net of taxes. Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in the consolidated statements of income.

g. Inventories:

Inventories are stated at the lower of cost or market value. Inventory write-offs and write-down provisions are provided to cover risks arising from slow-moving items or technological obsolescence and for market prices lower than cost. The Company periodically evaluates the quantities on hand relative to current and historical selling prices and historical and projected sales volume. Based on this evaluation, provisions are made to write inventory down to its market value. In 2005, 2004 and 2003, the Company wrote off $1,062,336, $121,322 and $96,350 of obsolete inventory respectively, which has been included in the cost of revenues.

Cost is determined as follows:

Raw and packaging materials – by the average cost method.

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Work in progress – represents the cost of manufacturing with additions of allocable indirect manufacturing cost.

Finished products – on the basis of direct manufacturing costs with additions of allocable indirect manufacturing costs.

h. Property and equipment:

Property and equipment are stated at cost net of accumulated depreciation and investment grants received from the State of Israel for investments in fixed assets under the Investment Law (no investment grants were received during 2005, 2004 and 2003).

Depreciation is calculated by the straight-line method over the estimated useful lives of the assets, at the following annual rates:

	%
Computers and related equipment	33
Motor vehicles	15
Office furniture and equipment	6 - 10
Machinery and equipment	10 - 25 (mainly 10)
Leasehold improvements	By the shorter of the term of the lease and the life of the asset

i. Goodwill:

Goodwill represents the excess of cost over the fair value of the net assets of businesses acquired. Under Statement of Financial Accounting Standard No. 142, "Goodwill and Other Intangible Assets" ("SFAS No, 142") goodwill acquired in a business combination on or after July 1, 2001, is not amortized after January 1, 2002.

SFAS No. 142 requires goodwill to be tested for impairment on adoption of the Statement and at least annually thereafter or between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of the Company's reportable units with their carrying value. Fair value is determined using discounted cash flows. Significant estimates used in the methodologies include estimates of future cash flows, future short-term and long-term growth rates, weighted average cost of capital and estimates of market multiples for the reportable units.

See Note 1.f. regarding the impairment test.

j. Long-lived assets:

Intangible assets acquired in a business combination that are subject to amortization are amortized over their useful life using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, in accordance with SFAS No. 142.

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The acquired trademarks and tradenames are deemed to have an indefinite useful life because they are expected to contribute to cash flows indefinitely. Therefore, the trademarks will not be amortized until their useful life is no longer indefinite. The trademarks and tradenames are tested annually for impairment in accordance FAS 142.

The Company and its subsidiaries' long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with Statement of Financial Accounting Standard No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144") whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the carrying amount of assets to be held and used is measured by a comparison of the carrying amount of the assets to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets

See Note 1.f. regarding the impairment test.

k. Revenue recognition:

The Company is a defense and security products and services company, engaged in three business areas: interactive simulation for military, law enforcement and commercial markets; batteries and charging systems for the military; and high-level armoring for military, paramilitary and commercial vehicles. During 2005, the Company and its subsidiaries recognized revenues as follows: (i) from the sale and customization of interactive training systems and from the maintenance services in connection with such systems (Simulation and Training Division); (ii) from revenues under armor contracts and for service and repair of armored vehicles (Armor Division); (iii) from the sale of batteries, chargers and adapters to the military, and under certain development contracts with the U.S. Army (Battery and Power Systems Division); and (iv) from the sale of lifejacket lights (Battery and Power Systems Division.

Revenues from the Battery and Power Systems Division products and Armor Division are recognized in accordance with SEC Staff Accounting Bulletin No. 104, "Revenue Recognition" when persuasive evidence of an agreement exists, delivery has occurred, the fee is fixed or determinable, collectability is probably, and no further obligation remains.

Revenues from contracts that involve customization of FAAC's simulation system to customer specific specifications are recognized in accordance with Statement Of Position 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts," using contract accounting on a percentage of completion method, in accordance with the "Input Method." The amount of revenue recognized is based on the percentage to completion achieved. The percentage to completion is measured by monitoring progress using records of actual time incurred to date in the project compared to the total estimated project requirement, which corresponds to the costs related to earned revenues. Estimates of total project requirements are based on prior experience of customization, delivery and acceptance of the same or similar technology and are reviewed and updated regularly by management. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss on the entire contract. As of December 31, 2005, $485,877 estimated losses were identified.

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The Company believes that the use of the percentage of completion method is appropriate as the Company has the ability to make reasonably dependable estimates of the extent of progress towards completion, contract revenues and contract costs. In addition, contracts executed include provisions that clearly specify the enforceable rights regarding services to be provided and received by the parties to the contracts, the consideration to be exchanged and the manner and the terms of settlement, including in cases of terminations for convenience. In all cases the Company expects to perform its contractual obligations and its customers are expected to satisfy their obligations under the contract.

Revenues from simulators, which do not require significant customization, are recognized in accordance with Statement of Position 97-2, “Software Revenue Recognition,” (“SOP 97-2”). SOP 97-2 generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair value of the elements. The Company has adopted Statement of Position 98-9, “Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions” (“SOP 98-9”). According to SOP No. 98-9, revenues are allocated to the different elements in the arrangement under the “residual method” when Vendor Specific Objective Evidence (“VSOE”) of fair value exists for all undelivered elements and no VSOE exists for the delivered elements. Under the residual method, at the outset of the arrangement with the customer, the Company defers revenue for the fair value of its undelivered elements (maintenance and support) and recognizes revenue for the remainder of the arrangement fee attributable to the elements initially delivered in the arrangement (software product) when all other criteria in SOP 97-2 have been met.

Revenue from such simulators is recognized when persuasive evidence of an agreement exists, delivery has occurred, no significant obligations with regard to implementation remain, the fee is fixed or determinable and collectibility is probable.

Maintenance and support revenue included in multiple element arrangements is deferred and recognized on a straight-line basis over the term of the maintenance and support services. Revenues from training are recognized when it is performed. The VSOE of fair value of the maintenance, training and support services is determined based on the price charged when sold separately or when renewed.

Unbilled receivables include cost and gross profit earned in excess of billing.

Deferred revenues include unearned amounts received under maintenance and support services and billing in excess of costs and estimated earnings on uncompleted contracts.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

l. Right of return:

When a right of return exists, the Company defers its revenues until the expiration of the period in which returns are permitted.

m. Warranty:

The Company offers up to one year warranty for most of its products. The specific terms and conditions of those warranties vary depending upon the product sold and country in which the Company does business. The Company estimates the costs that may be incurred under its basic limited warranty, including parts and labor. The Company estimates the costs that may be incurred under its basic limited warranty and records a liability in the amount of such costs as the time product revenue is recognized. Factors that affect the Company's warranty liability include the number of installed units, historical and anticipated rates of warranty claims, and cost per claim. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary. As of December 31, 2005, warranty liability is not material.

n. Research and development cost:

SFAS No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed," requires capitalization of certain software development costs, subsequent to the establishment of technological feasibility. Based on the Company's product development process, technological feasibility is established upon the completion of a working model or a detailed program design. Research and development costs incurred in the process of developing product improvements or new products, are generally charged to expenses as incurred, when applicable. Significant costs incurred by the Company between completion of the working model or a detailed program design and the point at which the product is ready for general release, have been capitalized. Capitalized software costs will be amortized by the greater of the amount computed using the: (i) ratio that current gross revenues from sales of the software bears to the total of current and anticipated future gross revenues from sales of that software, or (ii) the straight-line method over the estimated useful life of the product (two to five years). The Company assesses the recoverability of this intangible asset on a regular basis by determining whether the amortization of the asset over its remaining life can be recovered through undiscounted future operating cash flows from the specific software product sold. Based on its most recent analyses, management believes that no impairment of capitalized software development costs exists as of December 31, 2005

o. Income taxes:

The Company and its subsidiaries account for income taxes in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("SFAS No. 109"). This Statement prescribes the use of the liability method, whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company and its subsidiaries provide a valuation allowance, if necessary, to reduce deferred tax assets to its estimated realizable value.

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

p. Concentrations of credit risk:

Financial instruments that potentially subject the Company and its subsidiaries to concentrations of credit risk consist principally of cash and cash equivalents, restricted collateral deposit and restricted held-to-maturity securities, trade receivables and available for sale marketable securities. Cash and cash equivalents are invested mainly in U.S. dollar deposits with major Israeli and U.S. banks. Such deposits in the U.S. may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Company's investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

The trade receivables of the Company and its subsidiaries are mainly derived from sales to customers located primarily in the United States, Europe and Israel. Management believes that credit risks are moderated by the diversity of its end customers and geographical sales areas. The Company performs ongoing credit evaluations of its customers' financial condition. An allowance for doubtful accounts is determined with respect to those accounts that the Company has determined to be doubtful of collection.

The Company's available for sale marketable securities and held-to-maturity securities include investments in debentures of U.S. and Israeli corporations and state and local governments. Management believes that those corporations and states are institutions that are financially sound, that the portfolio is well diversified, and accordingly, that minimal credit risk exists with respect to these marketable securities.

The Company and its subsidiaries had no off-balance-sheet concentration of credit risk such as foreign exchange contracts, option contracts or other foreign hedging arrangements.

q. Basic and diluted net loss per share:

Basic net loss per share is computed based on the weighted average number of shares of common stock outstanding during each year. Diluted net loss per share is computed based on the weighted average number of shares of common stock outstanding during each year, plus dilutive potential shares of common stock considered outstanding during the year, in accordance with Statement of Financial Standards No. 128, "Earnings Per Share."

All outstanding stock options and warrants have been excluded from the calculation of the diluted net loss per common share because all such securities are anti-dilutive for all periods presented. The total weighted average number of shares related to the outstanding options and warrants excluded from the calculations of diluted net loss per share was 2,563,918, 2,250,154 and 1,585,301 for the years ended December 31, 2005, 2004 and 2003, respectively.

r. Accounting for stock-based compensation

The Company has elected to follow Accounting Principles Board Opinion No. 25 "Accounting for Stock Issued to Employees" ("APB No. 25") and Interpretation No. 44 "Accounting for Certain Transactions Involving Stock Compensation" in accounting for its employee stock option plans. Under APB No. 25, when the exercise price of the Company's share options is less than the market price of the underlying shares on the date of grant, compensation expense is recognized. Under Statement of Financial Accounting Standard No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"), pro-forma information regarding net income and net income per share is required, and has been determined as if the Company had accounted for its employee stock options under the fair value method of SFAS No. 123.

In U.S. dollars

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The Company applies SFAS No. 123 and Emerging Issue Task Force No. 96-18 "Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" ("EITF 96-18") with respect to options issued to non-employees. SFAS No. 123 requires use of an option valuation model to measure the fair value of the options at the grant date.

The fair value for the options to employees was estimated at the date of grant, using the Black-Scholes Option Valuation Model, with the following weighted-average assumptions: risk-free interest rates of 4.28%, 3.63% and 2.54% for 2005, 2004 and 2003, respectively; a dividend yield of 0.0% for each of those years; a volatility factor of the expected market price of the common stock of 0.76 for 2005, 0.81 for 2004 and 0.67 for 2003; and a weighted-average expected life of the option of three years for 2005, and five years for 2004 and 2003.

The following table illustrates the effect on net income and earnings per share, assuming that the Company had applied the fair value recognition provision of SFAS No. 123 on its stock-based employee compensation:

	Year ended December 31,		
	2005	2004	2003
Net loss as reported	$ (24,043,411)	$ (9,042,313)	$ (9,237,621)
Add: Stock-based compensation expenses included in reported net loss	674,712	831,626	8,286
Deduct: Stock-based compensation expenses determined under fair value method for all awards	(2,461,787)	(2,741,463)	(1,237,558)
	$ (25,830,486)	$ (10,952,150)	$ (10,466,893)
Loss per share:			
Basic and diluted, as reported	$ (4.09)	$ (2.48)	$ (3.45)
Diluted, pro forma	$ (4.40)	$ (2.19)	$ (3.77)

s. Fair value of financial instruments:

The following methods and assumptions were used by the Company and its subsidiaries in estimating their fair value disclosures for financial instruments:

The carrying amounts of cash and cash equivalents, restricted collateral deposit and restricted held-to-maturity securities, trade receivables, short-term bank credit, and trade payables approximate their fair value due to the short-term maturity of such instruments.

The fair value of available for sale marketable securities is based on the quoted market price.

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Long-terms promissory notes are estimated by discounting the future cash flows using current interest rates for loans or similar terms and maturities. The carrying amount of the long-term liabilities approximates their fair value.

t. Severance pay:

The Company's liability for severance pay is calculated pursuant to Israeli severance pay law based on the most recent salary of the employees multiplied by the number of years of employment as of the balance sheet date. Israeli employees are entitled to one month's salary for each year of employment, or a portion thereof. The Company's liability for all of its employees is fully provided by monthly deposits with severance pay funds, insurance policies and by an accrual. The value of these policies is recorded as an asset in the Company's balance sheet.

In addition and according to certain employment agreements, the Company is obligated to provide for a special severance pay in addition to amounts due to certain employees pursuant to Israeli severance pay law. The Company has made a provision for this special severance pay in accordance with Statement of Financial Accounting Standard No. 106, "Employer's Accounting for Post Retirement Benefits Other than Pensions." As of December 31, 2005 and 2004, the accumulated severance pay in that regard amounted to $1,732,955 and $1,642,801, respectively.

Pursuant to the terms of the employment agreement between the Company and its Chief Executive Officer, funds to secure payment of the Chief Executive Officer's contractual severance are to be deposited in a Rabbi Trust for the benefit of the Chief Executive Officer, with payments to the Rabbi Trust to be made pursuant to an agreed-upon schedule. As of December 31, 2005, the balance of this Rabbi Trust was $454,859. Pursuant to the terms of the Rabbi Trust, funds in the Rabbi Trust continue to be owned by the Company, which benefits from all gains and bears the risk of all losses resulting from investments of Rabbi Trust funds.

The deposited funds include profits accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israeli severance pay law or labor agreements. The value of the deposited funds is based on the cash surrendered value of these policies and includes immaterial profits.

Severance expenses for the years ended December 31, 2005, 2004 and 2003 amounted to $639,952, $460,178 and $219,857, respectively.

u. Advertising costs:

The Company and its subsidiaries expense advertising costs as incurred. Advertising expense for the years ended December 31, 2005, 2004 and 2003 was approximately $149,781, $13,271 and $34,732, respectively.

v. New accounting pronouncements:

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payments" ("SFAS 123(R)"), which is a revision of FASB No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). Generally, the approach in SFAS 123(R) is similar to the approach described in Statement 123. However, SFAS 123 permitted, but not required, share-based payments to employees to be recognized based on their fair values while SFAS 123(R) requires all share-based payments to employees to be recognized based on their fair values. SFAS 123(R) also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. The new standard will be effective for the Company in the first interim period beginning after December 15, 2005.

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Statement 123(R) permits public companies to adopt its requirements using one of two methods:

1. A "modified prospective" method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of Statement 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of Statement 123 for all awards granted to employees prior to the effective date of Statement 123(R) that remain unvested on the effective date.

2. A "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under Statement 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

The Company plans to adopt SFAS No. 123(R) using the modified prospective method.

As permitted by Statement 123, the Company currently accounts for share-based payments to employees using Opinion 25's intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options. Accordingly, the adoption of Statement 123(R)'s fair value method will have a significant impact on the Company's result of operations, although it will have no impact on the Company's overall financial position. The impact of adoption of Statement 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, had the Company adopted Statement 123(R) in prior periods, the impact of that standard would have approximated the impact of Statement 123 as described in the disclosure of pro forma net income and earnings per share in Note 2.r. above to the Company's consolidated financial statements. Statement 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature.

In March 2005, the SEC released Staff Accounting Bulletin No. 107, "Share-Based Payment" ("SAB 107"). SAB 107 provides the SEC staff position regarding the application of SFAS No. 123R. SAB 107 contains interpretive guidance related to the interaction between SFAS No. 123R and certain SEC rules and regulations, as well as provides the Staff's views regarding the valuation of share-based payment arrangements for public companies. SAB 107 also highlights the importance of disclosures made related to the accounting for share-based payment transactions. The Company expects that the adoption of SAB 107 will have an impact on its results of operations and net earnings per share as the Company will be required to expense the fair value of all share-based payments.

In U.S. dollars

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In May 2005, the FASB issued Statement of Financial Accounting Standard No. 154 ("FAS 154"), "Accounting Changes and Error Corrections," a replacement of APB No. 20,"Accounting Changes" and FAS No. 3, "Reporting Accounting Changes in Interim Financial Statements." FAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. APB Opinion 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. FAS 154 requires retrospective application to prior periods' financial statements of a voluntary change in accounting principle unless it is impracticable. FAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company is currently assessing the impact of FAS 154 on its results of operations, financial condition and liquidity.

In November 2004, the FASB issued Statement of Financial Accounting Standard No. 151, "Inventory Costs, an Amendment of ARB No. 43, Chapter 4." ("SFAS No. 151"). SFAS No. 151 amends Accounting Research Bulletin ("ARB") No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight handling costs and wasted materials (spoilage) should be recognized as current-period charges. In addition, SFAS No. 151 requires that the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not expect that the adoption of SFAS No. 151 will have a material effect on its financial position or results of operations

In November 2005, the FASB issued FASB Staff Position ("FSP") Financial Accounting Standard ("FAS") 115-1 and FAS 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" ("FSP 115-1"), which provides guidance on determining when investments in certain debt and equity securities are considered impaired, whether that impairment is other-than-temporary, and on measuring such impairment loss. FSP 115-1 also includes accounting considerations subsequent to the recognition of an other-than temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. FSP 115-1 is required to be applied to reporting periods beginning after December 15, 2005 and is required to be adopted by the Company in the second quarter of fiscal 2006. The Company does not expect the adoption of FSP 115-1 to have a significant effect on its consolidated financial statements.

w. Reclassification:

Certain prior period amounts have been reclassified to conform to the current period presentation.

In U.S. dollars

NOTE 3:- RESTRICTED COLLATERAL DEPOSITS AND RESTRICTED HELD-TO-MATURITY SECURITIES:

	December 31,	
	2005	**2004**
Short-term:		
Restricted, held to maturity, bonds in connection with FAAC earn out (Note 1.c.)(1)	$ —	$ 5,969,413
AoA earnout (Note 1.d.)	1,795,850	—
Deposits in connection with FAAC projects	548,973	650,989
Restricted cash in connection with interest payment to convertible debenture holders.	1,395,079	—
Other	157,211	341,708
Total short-term	3,897,113	6,962,110
Long-term:		
Restricted cash in connection with interest payment to convertible debenture holders.	779,286	—
Restricted cash in connection with AoA earn out (Note 1.d.)	—	3,000,000
Restricted deposit in connection with Epsilor acquisition (Note 1.b.)	—	1,000,000
Total long-term	779,286	4,000,000
	$ 4,676,399	$ 10,962,110

(1) The following is a summary of held-to-maturity securities at December 31, 2005 and 2004:

	Amortized cost		Unrealized losses		Estimated fair value	
	2005	2004	2005	2004	2005	2004
Obligations of States and political subdivisions	$ —	$ 1,012,787	$ —	$ (1,870)	$ —	$ 1,010,917
Corporate obligations	—	4,956,626	—	(11,966)	—	4,944,660
	$ —	$ 5,969,413	$ —	$ (13,836)	$ —	$ 5,955,577

The unrealized losses in the Company's investments were caused by interest rate increases. It is expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Based on the immaterial severity of the impairments and the obligation of the Company to hold these investments until maturity, the bonds were not considered to be other than temporarily impaired at December 31, 2004.

NOTE 4: - AVAILABLE FOR SALE MARKETABLE SECURITIES

The following is a summary of investments in marketable securities as of December 31, 2005 and 2004:

	Cost		Unrealized gains		Estimated fair value	
	2005	**2004**	**2005**	**2004**	**2005**	**2004**
Available for sale marketable securities	$ 32,558	$ 130,061	$ 3,426	$ 5,507	$ 35,984	$ 135,568

In U.S. dollars

NOTE 5:- OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	December 31, 2005	December 31, 2004
Government authorities	$ 460,265	$ 433,427
Employees	65,735	217,948
Prepaid expenses	1,360,589	490,357
Deferred taxes	64,820	135,482
Other	312,922	62,179
	$ 2,264,331	$ 1,339,393

NOTE 6:- INVENTORIES

	December 31, 2005	December 31, 2004
Raw and packaging materials	$ 3,296,453	$ 3,969,400
Work in progress	3,697,361	1,996,139
Finished products	821,992	1,311,762
	$ 7,815,806	$ 7,277,301

NOTE 7:- PROPERTY AND EQUIPMENT, NET

a. Composition of property and equipment is as follows:

	December 31, 2005	December 31, 2004
Cost:		
Computers and related equipment	$ 3,081,029	$ 2,788,398
Motor vehicles	704,718	620,001
Office furniture and equipment	786,958	830,621
Machinery, equipment and installations	7,716,598	7,464,470
Leasehold improvements	1,399,683	1,321,025
Demo inventory	369,995	141,961
	$ 14,058,981	$ 13,166,476
Accumulated depreciation:		
Computers and related equipment	2,328,549	1,995,392
Motor vehicles	233,745	163,817
Office furniture and equipment	474,127	451,998
Machinery, equipment and installations	5,729,563	5,143,186
Leasehold improvements	974,666	811,392
Demo inventory	65,400	—
	9,806,050	8,565,785
Depreciated cost	$ 4,252,931	$ 4,600,691

In U.S. dollars

b. Depreciation expense amounted to $1,308,180, $1,199,465 and $730,159 for the years ended December 31, 2005, 2004 and 2003, respectively.

As for liens, see Note 11.d.

NOTE 8:- OTHER INTANGIBLE ASSETS, NET

a.

	Year ended December 31,	
	2005	**2004**
Cost:		
Technology	$ 6,841,746	$ 6,841,746
Capitalized software costs	1,226,579	574,967
Backlog	2,194,000	2,194,000
Covenants not to compete	359,000	359,000
Customer list	7,548,645	7,548,645
Certification	246,969	246,969
	18,416,939	17,765,327
Exchange differences	(171,587)	125,455
Less - accumulated amortization	(7,267,630)	(4,070,802)
Less - impairment	(819,223)	(320,279)
Amortized cost	10,158,499	13,499,701
Trademarks	869,000	869,000
	$ 11,027,499	$ 14,368,701

b. Amortization and impairment expenses amounted to $3,695,772, $2,888,226 and $879,311 for the years ended December 31, 2005, 2004 and 2003.

c. Estimated amortization expenses, except capitalized software costs, for the years ended

Year ended December 31,	
2006	$ 1,825,331
2007	1,381,883
2008	1,276,075
2009	1,235,632
2010 and forward	3,467,873
	$ 9,186,794

NOTE 9:- SHORT-TERM BANK CREDIT AND LOANS

The Company has a $5.2 million authorized credit line from certain banks, of which $206,000 is denominated in NIS and carries an interest rate of approximately prime + 2.8% and $ 5.0 million of which is denominated in dollars and carries an interest rate of prime + 0.25%. As of December 31, 2005, $4.0 million was utilized, out of which $2.0 million is related to letter of credit issued to one of the customers of one of the Company's subsidiaries.

This line of credit is secured by the accounts receivable, inventory and marketable securities of the relevant subsidiary of the Company.

In U.S. dollars

In addition the Company has an automobile purchase loan, that will be repaid in June 2006. This loan is denominated in NIS and carries an interest rate of 6.0%. The loan is secured by the automobile purchased with the proceeds of the loan.

NOTE 10:- OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES

	December 31,	
	2005	**2004**
Employees and payroll accruals	$ 1,443,154	$ 1,534,295
Accrual for expected loss	485,877	—
Accrued vacation pay	504,342	469,527
Accrued expenses	1,788,558	1,770,348
Minority balance	172,871	243,116
Government authorities	439,975	1,036,669
Advances from customers	795,331	746,819
Other	—	17,414
	$ 5,630,108	$ 5,818,188

NOTE 11:- COMMITMENTS AND CONTINGENT LIABILITIES

a. Royalty commitments:

1. Under EFL's research and development agreements with the Office of the Chief Scientist ("OCS"), and pursuant to applicable laws, EFL is required to pay royalties at the rate of 3%-3.5% of net sales of products developed with funds provided by the OCS, up to an amount equal to 100% of research and development grants received from the OCS (linked to the U.S. dollars. Amounts due in respect of projects approved after year 1999 also bear interest at the Libor rate). EFL is obligated to pay royalties only on sales of products in respect of which OCS participated in their development. Should the project fail, EFL will not be obligated to pay any royalties.

Royalties paid or accrued for the years ended December 31, 2005, 2004 and 2003 to the OCS amounted to $28,502, $17,406 and $435, respectively.

As of December 31, 2005, the total contingent liability to the OCS was approximately $10,261,000. The Company regards the probability of this contingency coming to pass in any material amount to be low.

2. EFL, in cooperation with a U.S. participant, has received approval from the Israel-U.S. Bi-national Industrial Research and Development Foundation ("BIRD-F") for 50% funding of a project for the development of a hybrid propulsion system for transit buses. The maximum approved cost of the project is approximately $1.8 million, and the EFL's share in the project costs is anticipated to amount to approximately $1.1 million, which will be reimbursed by BIRD-F at the aforementioned rate of 50%. Royalties at rates of 2.5%-5% of sales are payable up to a maximum of 150% of the grant received, linked to the U.S. Consumer Price Index. Accelerated royalties are due under certain circumstances.

In U.S. dollars

NOTE 11:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

EFL is obligated to pay royalties only on sales of products in respect of which BIRD-F participated in their development. Should the project fail, EFL will not be obligated to pay any royalties.

No royalties were paid or accrued to the BIRD-F in each of the three years in the period ended December 31, 2005.

As of December 31, 2005, the total contingent liability to pay BIRD-F (150%) was approximately $772,000. The Company regards the probability of this contingency coming to pass in any material amount to be low.

b. Lease commitments:

The Company and its subsidiaries rent their facilities under various operating lease agreements, which expire on various dates, the latest of which is in 2009. The minimum rental payments under non-cancelable operating leases are as follows:

	Year ended December 31	
2006	$	826,367
2007	$	685,552
2008	$	213,909
2009	$	103,715
2010	$	96,840

Total rent expenses for the years ended December 31, 2005, 2004 and 2003 were approximately $1,022,396, $868,900 and $484,361, respectively.

c. Guarantees:

The Company obtained bank guarantees in the amount of $202,000 in connection (i) obligations of two of the Company's subsidiaries to the Israeli customs authorities and (ii) obligation of one of the Company's subsidiaries to secure inventory received from one of its customers. In addition, the Company issued a letter of credit in amount of $2,000,000 to one of its subsidiary's customers.

The Company's active United States subsidiaries act as guarantors of the Company's obligations under its senior secured convertible notes.

d. Liens:

As security for compliance with the terms related to the investment grants from the State of Israel, EFL and Epsilor have registered floating liens on all of its assets, in favor of the State of Israel.

The Company has granted to the holders of its 8% secured convertible debentures a first position security interest in (i) the shares of MDT Armor Corporation, (ii) the assets of its IES Interactive Training, Inc. subsidiary, (iii) the shares of all of its subsidiaries, and (iv) any shares that the Company acquires in future Acquisitions (as defined in the securities purchase agreement).

In U.S. dollars

NOTE 11:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

The Company has granted to the holders of its senior secured convertible notes (i) a second position security interest in the stock of MDT Armor Corporation, IES Interactive Training, Inc. and M.D.T. Protective Industries, Ltd. (junior to the security interest of the holders of its 8% secured convertible debentures) and in the assets of FAAC Incorporated (junior to the security interest of a bank that extends to FAAC Corporation a $5 million line of credit) and in any stock that the Company acquires in future Acquisitions (as defined in the securities purchase agreement) and (ii) a first position security interest in the assets of all of the Company's other active United States subsidiaries.

EFL has granted to its former CEO a security interest in certain of its property located in Beit Shemesh, Israel, to secure sums due to him pursuant to the terms of the settlement agreement with him.

FAAC has a $5.0 million line of credit secured by all of its accounts receivable, unbilled revenues and inventory.

Epsilor has recorded a lien on all of its assets in favor of its banks to secure lines of credit and loans received. In addition the company has a specific pledge on assets in respect of which government guaranteed loan were given.

See also Note 7 regarding automobiles purchased in EFL and Epsilor.

e. Litigation and other claims:

As of December 31, 2005, there were no pending legal proceedings to which the Company was a party, other than ordinary routine litigation incidental to its business, except as follows:

1. In December 2004, AoA filed an action against a U.S. government defense agency, seeking approximately $2.2 million in damages for alleged improper termination of a contract. In its answer, the government agency counterclaimed, seeking approximately $2.1 million in reprocurement expenses. AoA is preparing its answer to the counterclaim. At this stage in the proceedings, the Company and its legal advisors cannot determine with any certainty whether AoA will have any liability and, if so, the extent of that liability.

2. In the beginning of 2005 a competitor of FAAC brought an action against FAAC and a municipal transport agency, alleging, *inter alia*, that the municipal transport agency and FAAC have conspired to violate federal and state antitrust laws and have engaged in unfair competition with respect to this competitor. The competitor seeks unspecified monetary damages from FAAC and the municipal transport agency and injunctive relief. A motion to dismiss brought by FAAC and the municipal transport agency is pending. At this stage in the proceedings, the Company and its legal advisors cannot determine with any certainty whether FAAC will have any liability and, if so, the extent of that liability.

3. The Company has received a preliminary indication that there may be a dispute regarding the amount that it owes the former shareholders of FAAC Incorporated in respect of their earnout for 2005. Pursuant to the purchase agreement and a side letter, the Company is obligated to pay the former shareholders of FAAC an amount equal to "the net income realized by FAAC Incorporated from the Stryker Driver Simulator Program with the U.S. Army." Subsequently, the U.S. Army added additional programs, all of which it classified generally as the "Common Driver Training Program" (CDT). The former shareholders of FAAC have indicated their belief that the 2005 earnout is due on the entire CDT program, which would equal an additional amount of $3.5 million. The Company, on advice of counsel, takes the position that the 2005 earnout is due only on the Stryker part of the CDT program, relying on the specific language of the side letter. While this is a factual issue as to which there can be no clear answer, the Company believes it has the stronger argument in this matter. Based on the Company's and its counsel's position, the Company accrued the amount of $603,764 in respect of 2005 earnout as of December 31, 2005.

In U.S. dollars

NOTE 12:- CONVERTIBLE DEBENTURES AND DETACHABLE WARRANTS

a. 9% Secured Convertible Debentures due June 30, 2005

Pursuant to the terms of a Securities Purchase Agreement dated December 31, 2002, the Company issued and sold to a group of institutional investors an aggregate principal amount of 9% secured convertible debentures in the amount of $3.5 million due June 30, 2005. These debentures are convertible at any time prior to June 30, 2005 at a conversion price of $10.50 per share, or a maximum aggregate of 333,333 shares of common stock. The conversion price of these debentures was adjusted to $8.96 per share in April 2003. In accordance with EITF 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments," the terms of convertible debentures were not treated as changed or modified when the cash flow effect on a present value basis was less than 10%.

As part of the securities purchase agreement on December 31, 2002, the Company issued to the purchasers of its 9% secured convertible debentures due June 30, 2005, warrants, as follows: (i) Series A Warrants to purchase an aggregate of 83,336 shares of common stock at any time prior to December 31, 2007 at a price of $11.76 per share; (ii) Series B Warrants to purchase an aggregate of 83,336 shares of common stock at any time prior to December 31, 2007 at a price of $12.46 per share; and (iii) Series C Warrants to purchase an aggregate of 83,336 shares of common stock at any time prior to December 31, 2007 at a price of $13.02 per share. The exercise price of these warrants was adjusted to $8.96 per share in April 2003.

This transaction was accounted according to APB No. 14 "Accounting for Convertible debt and Debt Issued with Stock Purchase Warrants" ("APB No. 14") and Emerging Issue Task Force No. 00-27 "Application of Issue No. 98-5 to Certain Convertible Instruments" ("EITF 00-27"). The fair value of these warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor 64%, dividend yields of 0% and a contractual life of five years.

In connection with these convertible debentures, the Company recorded a deferred debt discount of $1,890,000 with respect to the beneficial conversion feature and the discount arising from fair value allocation of the warrants according to APB No. 14, which is being amortized from the date of issuance to the stated redemption date - June 30, 2005 - or to the actual conversion date, if earlier, as financial expenses.

In U.S. dollars

NOTE 12:- CONVERTIBLE DEBENTURES AND DETACHABLE WARRANTS (Cont.)

During 2004, the remaining principal amount of $1,150,000 of 9% secured convertible debentures outstanding was converted into an aggregate of 128,348 shares of common stock.

During 2004, the Company recorded expenses of $372,600 attributable to amortization due to conversion of the convertible debenture into shares.

b. 8% Secured Convertible Debentures due September 30, 2006 and issued in September 2003

Pursuant to the terms of a Securities Purchase Agreement dated September 30, 2003, the Company issued and sold to a group of institutional investors an aggregate principal amount of 8% secured convertible debentures in the amount of $5.0 million due September 30, 2006. These debentures are convertible at any time prior to September 30, 2006 at a conversion price of $16.10 per share, or a maximum aggregate of 310,559 shares of common stock.

As of December 31, 2005, principal amount of $150,000 remained outstanding under these debentures.

As part of the securities purchase agreement on September 30, 2003, the Company issued to the purchasers of its 8% secured convertible debentures due September 30, 2006, warrants to purchase an aggregate of 89,286 shares of common stock at any time prior to September 30, 2006 at a price of $20.125 per share.

This transaction was accounted according to APB No. 14 “Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants” and Emerging Issue Task Force No. 00-27 “Application of Issue No. 98-5 to Certain Convertible Instruments.” The fair value of these warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 1.95%, a volatility factor 98%, dividend yields of 0% and a contractual life of three years.

In connection with these convertible debentures, the Company recorded a deferred debt discount of $2,963,043 with respect to the beneficial conversion feature and the discount arising from fair value allocation of the warrants according to APB No. 14, which is being amortized from the date of issuance to the stated redemption date - September 30, 2006 - or to the actual conversion date, if earlier, as financial expenses.

During 2004, an aggregate of principal amount $1,075,000 in 8% secured convertible debentures was converted into an aggregate of 66,770 shares.

During 2004 and 2005, the Company recorded expenses of $613,263 and 29,603, respectively, of which $191,895 and 29,603, respectively, was attributable to amortization of the beneficial conversion feature of the convertible debenture over its term and $421,368 and 0, respectively, was attributable to amortization due to conversion of the convertible debenture into shares.

In U.S. dollars

NOTE 12:- CONVERTIBLE DEBENTURES AND DETACHABLE WARRANTS (Cont.)

c. 8% Secured Convertible Debentures due September 30, 2006 and issued in December 2003

Pursuant to the terms of a Securities Purchase Agreement dated September 30, 2003, the Company issued and sold to a group of institutional investors an aggregate principal amount of 8% secured convertible debentures in the amount of $6.0 million due September 30, 2006. These debentures are convertible at any time prior to September 30, 2006 at a conversion price of $20.30 per share, or a maximum aggregate of 295,567 shares of common stock.

As of December 31, 2005, principal amount of $4,387,500 remained outstanding under these convertible debentures.

As a further part of the securities purchase agreement on September 30, 2003, the Company issued to the purchasers of its 8% secured convertible debentures due September 30, 2006, warrants to purchase an aggregate of 107,143 shares of common stock at any time prior to December 18, 2006 at a price of $25.375 per share. Additionally, the Company issued to the investors supplemental warrants to purchase an aggregate of 74,143 shares of common stock at any time prior to December 31, 2006 at a price of $30.80 per share.

This transaction was accounted according to APB No. 14 “Accounting for Convertible debt and Debt Issued with Stock Purchase Warrants” and Emerging Issue Task Force No. 00-27 “Application of Issue No. 98-5 to Certain Convertible Instruments.” The fair value of these warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 2.45%, a volatility factor 98%, dividend yields of 0% and a contractual life of three years.

In connection with these convertible debentures, the Company recorded a deferred debt discount of $6,000,000 with respect to the beneficial conversion feature and the discount arising from fair value allocation to warrants according to APB No. 14, which is being amortized from the date of issuance to the stated redemption date - September 30, 2006 - or to the actual conversion date, if earlier, as financial expenses.

During 2004 an aggregate of 107,143 shares were issued pursuant to exercise of these warrants. Out of these warrants, the holders of 80,357 warrants exercised their warrants on July 14, 2004 were granted an additional warrants to purchase 80,357 shares of common stock of the Company at an exercise price per share of $19.32. See also Note 13.f.3.

During 2004 and 2005, the Company recorded expenses of $3,156,246 and $1,562,378, respectively, of which $1,782,561 and $1,562,378, respectively, was attributable to amortization of the beneficial conversion feature of the convertible debenture over its term and $1,373,685 and $0, respectively, was attributable to amortization due to conversion of the convertible debenture into shares.

d. Senior Secured Convertible Notes due March 31, 2008

Pursuant to the terms of a Securities Purchase Agreement dated September 29, 2005 (the “Purchase Agreement”) by and between the Company and certain institutional investors, the Company issued and sold to the investors an aggregate of $17.5 million principal amount of senior secured notes having a final maturity date of March 31, 2008.

In U.S. dollars

NOTE 12:- CONVERTIBLE DEBENTURES AND DETACHABLE WARRANTS (Cont.)

Under the terms of the Purchase Agreement, the Company granted the investors (i) a second position security interest in the stock of MDT Armor Corporation, IES Interactive Training, Inc. and M.D.T. Protective Industries, Ltd. (junior to the security interest of the holders of the Company's 8% secured convertible debentures due September 30, 2006)and in the assets of FAAC Incorporated (junior to a bank that extends to FAAC Incorporated a $5 million line of credit) and in any stock that the Company acquires in future acquisitions, and (ii) a first position security interest in the assets of all of the Company's other active United States subsidiaries. The Company's active United States subsidiaries are also acting as guarantors of the Company's obligations under the Notes.

As of December 31, 2005, principal amount of $17.0 million remained outstanding under these convertible notes.

The Notes are convertible at the investors' option at a fixed conversion price of $14.00. The Notes bear interest at a rate equal to six month LIBOR plus 6% per annum, subject to a floor of 10% and a cap of 12.5%. The Company will repay the principal amount of the Notes over a period of two and one-half years, with the principal amount being amortized in twelve payments payable at the Company's option in cash and/or stock, provided certain conditions are met. In the event the Company elects to make such payments in stock, the price used to determine the number of shares to be issued will be calculated using an 8% discount to the average trading price of the Company's common stock during 17 of the 20 consecutive trading days ending two days before the payment date.

As a further part of the Securities Purchase Agreement dated September 29, 2005, the Company issued warrants, which are not exercisable for the six month period following closing, to purchase up to 375,000 shares of common stock (30% warrant coverage) at an exercise price of $15.40 per share. These warrants are exercisable until the one-year anniversary of the effective date of the registration statement registering the shares of common stock underlying the warrants.

This transaction was accounted according to APB No. 14, "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants" and Emerging Issue Task Force No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments" ("EITF 00-27"). The fair value of the warrants granted in respect of convertible debentures was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 3.87%, a volatility factor 53%, divi-dend yields of 0% and a contractual life of one year.

In connection with these convertible notes, the Company recorded a deferred debt discount of $422,034 with respect to the discount arising from fair value allocation of the warrants according to APB No. 14, which is being amortized from the date of issuance to the stated redemption date - March 31, 2008 - or the actual conversion date, if earlier, as financial expenses.

In U.S. dollars

NOTE 12:- CONVERTIBLE DEBENTURES AND DETACHABLE WARRANTS (Cont.)

The Company has also considered EITF No. 05-2, "The Meaning of Conventional Convertible Debt Instrument" in EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock.". Accordingly, the Company has concluded that these convertible notes would be considered as conventional convertible debt and therefore EITF 00-19 do not apply to them.

As to EITF 00-19, since the terms of the warrants referred to above provided that upon exercise of a warrant the Company could issue only stock that had been registered with the SEC (which occurred in December 2005) and therefore freely tradable, in accordance with Emerging Issues Task Force No 00-19 "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," their fair value was recorded as a liability at the closing date. Such fair value was remeasured at each subsequent cut-off date. The fair value of these warrants was remeasured as at December 31, 2005 using the Black-Scholes pricing model assuming a risk free interest rate of 3.87%, a volatility factor of 64%, dividend yields of 0% and a contractual life of approximately nine months. The change in the fair value of the warrants between the date of the grant and December 31, 2005 in the amount of $377,803 has been recorded as finance income.

During 2005, the Company recorded expenses of $110,771 attributable to amortization of the deferred debt discount arising from the fair value allocation of the warrants.

The Company's Notes provide for repayment in twelve equal installments. Installments may be paid in cash or, at the Company's option (subject to certain conditions), in stock. If the Company elects to make a payment in stock, it must give notice 24 trading days prior to the date the installment is due, and issue shares of its stock to the holders of the Note based on a conversion price of $14.00. Thereafter, based on a price of 92% of the average price of the stock during 17 of the trading days between the notice date and the installment payment date, the Company issues additional shares based on the amount, if any, by which the average price of the stock was less than $14.00. In December 2005, pursuant to the terms of the Notes, the Company made the first installment of a scheduled $1,458,333 principal repayment in shares of common stock by requesting its stock transfer agent to issue a total of 104,167 shares to the holders of the notes. Of these shares, 82,976 shares were issued prior to December 31, 2005, which at the share value assigned pursuant to the procedures established in the notes was equal to repayment of $453,051, and the remaining 21,191 shares were, for technical reasons, issued in early January 2006.

e. The Company's debt agreements contain customary affirmative and negative operations covenants that limit the discretion of its management with respect to certain business matters and place restrictions on it, including obligations on the Company's part to preserve and maintain assets and restrictions on its ability to incur or guarantee debt, to merge with or sell its assets to another company, and to make significant capital expenditures without the consent of the debenture holders, as well as granting to the Company's investors a right of first refusal on any future financings, except for underwritten public offerings in excess of $30 million. Management does not believe that this right of first refusal will materially limit the Company's ability to undertake future financings.

In U.S. dollars

NOTE 13:- STOCKHOLDERS' EQUITY

a. Stockholders' rights:

The Company's shares confer upon the holders the right to receive notice to participate and vote in the general meetings of the Company and right to receive dividends, if and when declared.

b. Issuance of common stock to investors and in respect of acquisitions:

1. In September 2003, the Company acquired an additional 12% interest in MDT Armor Corporation and an additional 24.5% interest in MDT Protective Industries, Ltd. in exchange for the issuance to AGA Means of Protection and Commerce, Ltd. of 9,000 shares of its common stock.

2. In January 2004, the Company issued an aggregate of 702,888 shares of common stock at a price of $26.32 per share, or a total purchase price of $18,500,000, to a several institutional (see also Note 13.f.2.). Finance expenses in connection with this issuance totaled $692,500.

3. In July 2004, pursuant to a Securities Purchase Agreement dated July 15, 2004, the Company issued an aggregate of 304,148 shares of common stock at a price of $21.70 per share, or a total purchase price of $6,600,000, to a group of investors (see also Note 13.f.3.).

4. In May 2005, the Company issued an aggregate of 91,107 shares of common stock at a price of $14.00 per share, or a total purchase price of $1,275,500, to several institutional investors.

5. In connection with the satisfaction by the Company of the provision of the FAAC purchase agreement related to an earn-out based on 2004 net pretax income, the Company, in May 2005, issued to the former shareholders of FAAC a total of 248,533 shares, which together with cash paid by the Company to the former shareholders of FAAC, was sufficient to satisfy the Company's obligation in respect of this earn-out provision.

c. Issuance of common stock to service providers and employees, in settlement of litigation, and as donations to charities

1. In July 2003, the Company issued 15,378 shares of common stock to a consultant as commissions on battery orders. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by the market price at the issuance date and by the value of the services provided and amounted to $154,331 in accordance with EITF 96-18. In accordance with EITF 96-18, the Company recorded this compensation expense of $154,331 during the year 2003 and included this amount in marketing expenses.

2. In November 2003, the Company issued 593 shares of common stock to a consultant as commissions on battery orders. At the issuance date, the fair value of these shares was determined by the fair market value of the shares issued as reflected by their market price at the issuance date and by the value of the services provided and amounted to $7,616 in accordance with EITF 96-18. In accordance with EITF 96-18, the Company recorded this compensation expense of $7,616 during the year 2003 and included this amount in marketing expenses.

In U.S. dollars

NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

3. Beginning in January 2004, the Company entered into a consulting agreement with one of its directors pursuant to which the director agreed to aid the Company in identifying potential acquisition candidates, in exchange for a commission. The Company also agreed to issue to this director, at par value, a total of 2,286 shares of its common stock, the value of which was to be deducted from any transaction fees paid. 1,143 of these shares were earned and issued prior to termination of this agreement in August 2004. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by their market price at the issuance date and by the value of the services provided and amounted to $28,160 in accordance with EITF 96-18. In accordance with EITF 96-18, the Company recorded this compensation expense of $28,160 during the year 2004 and included this amount in general and administrative expenses

4. In February 2004, the Company issued 5,301 shares of common stock to a consultant as commissions on battery orders. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by their market price at the issuance date and by the value of the services provided and amounted to $171,680 in accordance with EITF 96-18. In accordance with EITF 96-18, the Company accrued this compensation expense of $171,680 during the year 2003 and included this amount in selling and marketing expenses.

5. In June 2004 the Company sold 2,857 shares of the Company's common stock at a price of $14.00 per share to one of its employees. At the issuance date, the fair value of these shares was determined by the fair market value of the shares issued as reflected by their market price at the issuance date in accordance with APB No. 25. In accordance with APB No. 25, the Company recorded this compensation expense of $53,200 during the year 2004 and included this amount in general and administrative expenses

6. In December 2004, the Company donated 2,857 shares of its common stock to a charitable organization recognized by the Internal Revenue Service as tax-exempt under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended. At the issuance date, the fair value of these shares was determined by the value of the shares issued as reflected by their market price at the issuance date and amounted to $69,200 in accordance with EITF 96-18. This compensation expense will be amortized over the course of one year due to legal restrictions on selling these shares for that period of time. In accordance with EITF 96-18, the Company recorded compensation expense of $4,361 and $64,839 during the years 2004 and 2005, respectively, and included this amount in general and administrative expenses.

7. In May 2005, the Company issued 5,190 shares of common stock to a consultant as commissions on battery orders as a part of a marketing agreement with the consultant whereby he helped procure orders and ensured payment by a specified military agency for Zinc-Air batteries and complementary products. At the issuance date, the fair value of these shares was determined by the value of the shares issued as reflected by their market price at the issuance date and amounted to $89,363 in accordance with EITF 96-18. In accordance with EITF 96-18, the Company accrued compensation expenses of $56,577 and $32,786 during the years 2004 and 2005, respectively, and included these amounts in selling and marketing expenses.

In U.S. dollars

NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

8. In August 2005, pursuant to the terms of agreements between the Company and an investment banker, the Company issued an aggregate of 30,357 shares of common stock as part of the fee arrangements in connection with investment banking and financial consulting services that the investment banker rendered to it including arranging financing in connection with potential acquisitions. At the issuance date, the fair value of these shares was determined by the value of the shares issued as reflected by their market price at the issuance date and amounted to $423,750 in accordance with EITF 96-18. In accordance with EITF 96-18 the Company accrued compensation expenses of $423,750 during 2005 and included this amount in general and administrative expenses.

9. In August 2005, pursuant to the terms of an agreement between the Company and a public relations firm, the Company issued 686 shares of common stock as part of the fee arrangements in connection with investor relations services that the public relations firm rendered to it. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by their market price at the issuance date and by the value of the services provided and amounted to $8,160 in accordance with EITF 96-18. In accordance with EITF 96-18 the Company accrued compensation expenses of $8,160 during 2005 and included this amount in general and administrative expenses.

10. See Note 13.f.5.

d. Issuance of shares to lenders

As part of the securities purchase agreement on December 31, 2002 (see Note 12.a.), the Company issued 27,664 shares at par as consideration to lenders for the first nine months of interest expenses. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by their market price at the issuance date and by the value of the interest and amounted to $236,250 in accordance with APB 14. During 2003 the Company recorded this amount as financial expenses.

e. Issuance of promissory note:

As part of its purchase of the assets of IES Interactive Training, Inc., the Company issued a $450,000 convertible promissory note. This note was converted into an aggregate of 40,284 shares of common stock in August 2003.

f. Warrants:

1. As part of an investment agreement in May 2001, the Company issued to the investors a total of 192,641 warrants (the "May 2001 Warrants") to purchase shares of common stock at a price of $45.08 per share; these warrants are exercisable by the holder at any time after November 8, 2001 and will expire on May 8, 2006.

In June and July 2003, the Company adjusted the purchase price of 96,970 of the May 2001 Warrants to $11.48 per share in exchange for immediate exercise of these warrants, and issued to the holders of these exercised warrants new warrants to purchase a total of 64,647 shares of common stock at a purchase price of $20.30 per share (the "June 2003 Warrants"). The June 2003 Warrants were originally exercisable at any time from and after December 31, 2003 to June 30, 2008; however, in September 2003, the exercise period of 45,599 of these June 2003 Warrants was adjusted to make them exercisable at any time from and after December 31, 2004 to June 30, 2009. As a result the Company recorded during 2003 a deemed dividend in the amount of $267,026.

In U.S. dollars

NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

In addition, with respect to an additional 27,706 May 2001 Warrants, in December 2003 the Company adjusted the purchase price to $22.40 per share in exchange for immediate exercise of these warrants, and issued to the holders of these exercised warrants new warrants to purchase a total of 13,853 shares of common stock at a purchase price of $31.50 per share. As a result the Company recorded during 2003 a deemed dividend in the amount of $82,974.

Additionally, in October 2003 the Company granted to three of these investors additional new warrants to purchase a total of 10,714 shares of common stock at a purchase price of $16.80 per share. As a result the company recorded during 2003 an expense of $199,500 and included this amount in general and administrative expenses. During 2004, 4,611 warrants were exercised.

On July 14, 2004, the Company repriced the exercise price of 17,316 warrants granted previously in May 2001 to $26.32 in order to induce their holders to exercise them immediately. In connection with the exercise of the warrants, the Company additionally granted five-year warrants to purchase up to an aggregate of 10,390 shares of the Company's common stock at an exercise price per share of $19.32. The fair value of these warrants was determined using Black Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor of 79%, dividend yields of 0% and a contractual life of five years. For accounting treatment, please see also Notes 13.b.2. and 13.f.3.

2. In connection with the Securities Purchase Agreement referred to in Note 13.b.2 above, the Company granted three-year warrants to purchase up to an aggregate of 702,888 shares of the Company's common stock at any time beginning six months after closing at an exercise price per share of $26.32.

In July 2004 an aggregate of 531,915 shares were issued pursuant to exercise of these warrants. In connection with the exercise of the warrants, the Company granted to the same investors five-year warrants to purchase up to an aggregate of 531,915 shares of the Company's common stock at an exercise price per share of $19.32. The fair value of these warrants was determined using Black Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor of 79%, dividend yields of 0% and a contractual life of five years. See also Note 13.f.3.

3. On July 14, 2004, warrants to purchase 629,588 shares of common stock, having an aggregate exercise price of $16,494,194, net of issuance expenses, were exercised (see also Notes 13.f.1., 13.f.2. and 12.c.). Out of the shares issued in conjunction with the exercise of these warrants, 80,357 shares were issued upon exercise of warrants issued in the transaction referred to in Note 12.c. above and 531,915 shares were issued upon exercise of warrants issued in the transaction referred to in the Note 13.f.3. above; the remaining 17,316 shares were issued upon exercise of a warrant that the Company issued to an investor in May 2001 referred to in Note 13.f.1. above. In connection with this transaction, the Company issued to the holders of those exercising warrants an aggregate of 622,662 new five-year warrants to purchase shares of common stock at an exercise price of $19.32 per share

In U.S. dollars

NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

As a result of the transactions described in Notes 13.f.1., 13.f.2. and 12.c., including the repricing of the warrants to the investors and the issuance of additional warrants to the investors, the Company recorded a deemed dividend in the amount of $2,165,952, to reflect the additional benefit created for these investors. The deemed dividend increased the loss applicable to common stockholders in the calculation of basic and diluted net loss per share for the year ended December 31, 2004, without any effect on total shareholder's equity

As all warrants in the July 14, 2004, securities purchase agreement were subject to shareholders approval, in accordance with Emerging Issues Task Force No.00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" their fair value was recorded as a liability at the closing date. Such fair value was remeasured at each subsequent cut-off date. Upon obtaining stockholders approval on December 14, 2004, the warrants were remeasured and reclassified to equity. The fair value of these warrants was determined using the Black-Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor 79%, dividend yields of 0% and a contractual life of approximately five years. The change in the fair value of the warrants between the date of grant and December 14, 2004 has been recorded as finance income in the amount of $326,839.

4. In November 2000 and May 2001, the Company issued a total of 65,476 warrants to an investor, which warrants contained certain antidilution provisions: a Series A warrant to purchase 47,619 shares of the Company's common stock at a price of $49.00 per share, and a Series C warrant to purchase 17,857 shares at a price of $43.12 per share. Operation of the antidilution provisions provided that the Series A warrant should be adjusted to be a warrant to purchase 63,483 shares at a price of $37.38 per share, and the Series C warrant should be adjusted to be a warrant to purchase 23,806 shares at a price of $32.90 per share. After negotiations, the investor agreed in March 2004 to exercise its warrants immediately, in exchange for an exercise price reduction to $20.30 per share, and the issuance of a new six-month Series D warrant to purchase 87,289 shares at an exercise price of $29.40 per share. The new Series D warrant does not have similar antidilution provisions. As a result of this repricing and the issuance of new warrants, the Company recorded a deemed dividend in the amount of approximately $1,163,000 in 2004.

5. On February 4, 2004, the Company entered into an agreement settling the litigation brought against it in the Tel-Aviv, Israel district court by I.E.S. Electronics Industries, Ltd. ("IES Electronics") and certain of its affiliates in connection with the Company's purchase of the assets of its IES Interactive Training, Inc. subsidiary from IES Electronics in August 2002. The litigation had sought monetary damages in the amount of approximately $3 million. Pursuant to the terms of the settlement agreement, in addition to agreeing to dismiss their lawsuit with prejudice, IES Electronics agreed (i) to cancel the Company's $450,000 debt to them that had been due on December 31, 2003, and (ii) to transfer to the Company title to certain certificates of deposit in the approximate principal amount of $112,000. The parties also agreed to exchange mutual releases. In consideration of the foregoing, the Company issued to IES Electronics (i) 32,143 shares of common stock, and (ii) five-year warrants to purchase up to an additional 32,143 shares of common stock at a purchase price of $26.74 per share. The fair value of the warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor 79%, dividend yields of 0% and a contractual life of five years. The fair value of warrants was calculated as $483,828 and fair value of shares as $765,000.

In U.S. dollars

NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

In respect of the above settlement, the Company recorded in 2003 an expense of $688,642, representing the fair value of the warrants and shares over the remaining balance of the Company's debt to IES Electronics as carried in the Company books at December 31, 2003, less the $112,000 certificate of deposit that was transferred to the Company's name as noted above. During the year 2004, 200,000 warrants were exercised.

6. As of December 31, 2005, the Company's outstanding warrants totaled 1,575,819.

g. Stock option and restricted stock purchase plans:

1. Options and restricted shares to employees and others (except consultants)

a. The Company has adopted the following stock option plans, whereby options and restricted shares may be granted for purchase of shares of the Company's common stock. Under the terms of the employee plans, the Board of Directors or the designated committee grants options and determines the vesting period and the exercise terms.

1) 1998 Employee Option Plan - as amended, 339,286 shares reserved for issuance, of which 60,711 were available for future grants to employees and consultants as of December 31, 2005.

2) 1995 Non-Employee Director Plan - 71,429 shares reserved for issuance, of which 15,000 stock options were issued and outstanding as of December 31, 2005. Pursuant to the terms of this Plan, no new options were issuable under this Plan after September 28, 2005.

3) 2004 Employee Option Plan - 535,714 shares reserved for issuance, of which 301,813 were available for future grants to employees and consultants as of December 31, 2005.

b. Under these plans, options generally expire no later than 5-10 years from the date of grant. Each option can be exercised to purchase one share, conferring the same rights as the other common shares. Options that are cancelled or forfeited before expiration become available for future grants. The options generally vest over a three-year period (33.3% per annum) and restricted shares vest after two years; in the event that employment is terminated for cause within that period, restricted shares revert back to the Company.

c. A summary of the status of the Company's plans and other share options and restricted shares (except for options granted to consultants) granted as of December 31, 2005, 2004 and 2003, and changes during the years ended on those dates, is presented below:

In U.S. dollars

NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

	2005		2004		2003	
	Amount	**Weighted average exercise price**	**Amount**	**Weighted average exercise price**	**Amount**	**Weighted average exercise price**
		$		$		$
Options outstanding at be-ginning of year	703,912	$ 16.66	644,166	$ 19.18	375,741	$ 31.64
Changes during year:						
Granted (1) (2) (3)	121,096	$ 7.70	160,606	$ 14.84	376,019	$ 9.94
Exercised	(1,130)	$ 15.26	(64,089)	$ 17.36	(49,260)	$ 8.96
Forfeited (3)	(163,524)	$ 26.46	(36,771)	$ 52.78	(58,334)	$ 49.14
Repriced (3)						
Old exercise price	(207,980)	$ 15.40	—	—	—	—
New exercise price	207,980	$ 5.46	—	—	—	—
Options outstanding at end of year	660,354	$ 9.38	703,912	$ 16.66	644,166	$ 19.18
Options exercisable at end of year	583,070	$ 9.80	461,808	$ 18.48	416,181	$ 23.80

(1) Includes 24,276, 66,875 and 145,358 options and restricted shares granted to directors and executive officers in 2005, 2004 and 2003, respectively.

(2) The Company recorded deferred stock compensation for options and restricted shares issued with an exercise price below the fair value of the common stock in the amount of $51,000, $2,081,457 and $4,750 as of December 31, 2005, 2004 and 2003, respectively. In addition, in 2005, the Company decreased its deferred stock compensation in the amount of $245,280 due to cancellation of certain options and restricted shares of employees that their employment was terminated. Deferred stock compensation is amortized and recorded as compensation expenses ratably over the vesting period of the option or the restriction period of the restricted shares. The stock compensation expense that has been charged in the consolidated statements of operations in respect of options and restricted shares to employees and directors in 2005, 2004 and 2003 was $674,713, $831,626 and $8,286, respectively.

(3) On December 29, 2005 the company repriced downwards 207,980 options with average exercise price of $215.6 to $76.44. In addition, 4,205 options with exercise price of $184.24 were forfeited and new options with exercise price of $76.44 were given at the same day. In accordance with FIN44 the downward repricing resulted in a variable plan accounting. However, due to the decrease in the share price as of December 31, 2005 no compensation was recorded.

d. The options and restricted shares outstanding as of December 31, 2005 have been separated into ranges of exercise price, as follows:

In U.S. dollars

NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

Range of exercise prices	Total options outstanding			Exercisable options outstanding[1]	
	Amount outstanding at December 31, 2005	Weighted average remaining contractual life	Weighted average exercise price	Amount exercisable at December 31, 2005	Weighted average exercise price
$		Years	$		$
0.01–2.00	630,954	5.10	7.42	562,003	7.98
2.01–4.00	16,186	3.43	34.30	7,853	35.00
4.01–6.00	12,143	4.05	69.02	12,143	69.02
6.01–8.00	357	1.86	91.00	357	91.00
8.01	714	1.75	126.84	714	126.84
	660,354	5.04	9.38	583,070	9.80

On December 29, 2005, the Company accelerated vesting of 39,810 of its outstanding unvested stock options to make such options immediately vested and exercisable. The Company's decision to accelerate the vesting of those options and to grant fully vested options was based primarily upon the issuance of SFAS No. 123R, which will require the Company to treat all unvested stock options as compensation expense effective January 1, 2006. The Company believes that the acceleration of vesting of those options will enable the Company to avoid recognizing stock-based compensation expense associated with these options in future periods. Additional reasons for the fully vested grant and for the acceleration were to make the options more attractive to the recipients, and to avoid discrimination between groups of option holders, respectively.

Weighted-average fair values and exercise prices of options and restricted shares on dates of grant are as follows:

	Equals market price			Less than market price		
	Year ended December 31,			Year ended December 31,		
	2005	2004	2003	2005	2004	2003
Weighted average exercise prices	$ 7.00	$ 20.916	$ 13.30	$ —	$ 23.408	$ —
Weighted average fair value on grant date	$ 3.64	$ 14.028	$ 10.22	$ —	$ 24.206	$ —

2. Options issued to consultants:

a. The Company's outstanding options to consultants as of December 31, 2005, are as follows:

In U.S. dollars

NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

	2005		2004		2003	
	Amount	Weighted average exercise price	Amount	Weighted average exercise price	Amount	Weighted average exercise price
		$		$		$
Options outstanding at beginning of year	11,878	$ 53.20	22,422	$ 64.26	17,556	$ 77.70
Changes during year:						
Granted	—	$ —	714	$ —	5,937	$ 13.86
Exercised	—	$ —	(2,687)	$ 14.42	(1,071)	$ 6.86
Forfeited or cancelled	—	$ —	(8,571)	$ 89.60	—	$ —
Options outstanding at end of year	11,878	$ 53.20	11,878	$ 53.20	22,422	$ 64.26
Options exercisable at end of year	11,878	$ 53.20	11,878	$ 53.20	13,850	$ 48.44

b. The Company accounted for its options to consultants under the fair value method of SFAS No. 123 and EITF 96-18. The fair value for these options was estimated using a Black-Scholes option-pricing model with the following weighted-average assumptions:

	2005	2004	2003
Dividend yield	—	0%	0%
Expected volatility	—	81%	78%
Risk-free interest	—	3.4%	2.3%
Contractual life of up to	—	5 years	10 years

c. In connection with the grant of stock options to consultants, the Company recorded stock compensation expenses totaling $0, $0 and $29,759 for the years ended December 31, 2005, 2004 and 2003, respectively, and included these amounts in marketing and general and administrative expenses.

3. Dividends:

In the event that cash dividends are declared in the future, such dividends will be paid in U.S. dollars. The Company does not intend to pay cash dividends in the foreseeable future.

4. Treasury Stock:

Treasury stock is the Company's common stock that has been issued and subsequently reacquired. The acquisition of common stock is accounted for under the cost method, and presented as reduction of stockholders' equity.

h. Reverse split:

The Company's stockholders approved a one-for-fourteen reverse stock split of the Company's common stock on June 19, 2006, which was effected on June 21, 2006. As a result of the reverse stock split, every fourteen shares of Arotech common stock were combined into one share of common stock; any fractional shares created by the reverse stock split were eliminated. The reverse stock split affected all of Arotech's common stock, stock options, warrants and convertible debt outstanding immediately prior to the effective date of the reverse stock split. All shares of common stock, options, warrants, option and warrant exercise prices, convertible debt conversion prices and per share date included in these financial statements for all periods presented have been retroactively adjusted to reflect this one-for-fourteen reverse split.

NOTE 14:- INCOME TAXES

a. Taxation of U.S. parent company (Arotech) and other U.S. subsidiaries:

As of December 31, 2005, Arotech has operating loss carryforwards for U.S. federal income tax purposes of approximately $26 million, which are available to offset future taxable income, if any, expiring in 2009 through 2025. Utilization of U.S net operating losses may be subject to substantial annual limitations due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating loses before utilization.

In U.S. dollars

NOTE 14:- INCOME TAXES (Cont.)

The Company files consolidated tax returns with its US subsidiaries.

b. Israeli subsidiary (Epsilor):

Tax benefits under the Law for the Encouragement of Capital Investments, 1959 (the "Investments Law"):

Currently, Epsilor is operating under three programs as follows:

1. Program one:

Epsilor's expansion program of its existing enterprise in Dimona was granted the status of an "approved enterprise" under the Investments Law and was entitled to investments grants from the state of Israel in the amount of 24% on property and equipment located at its Dimona plant.

The approved expansion program was in the amount of approximately $350,000. Epsilor effectively operated the program during 1999 and is entitled to the tax benefits available under the Investments Law.

Taxable income derived from the approved enterprise is subject to a reduced tax rate during seven years beginning from the year in which taxable income is first earned (tax exemption for the first two-year period and 25% tax rate for the five remaining years).

Those benefits are limited to 12 years from the year that the enterprise began operations, or 14 years from the year in which the approval was granted, whichever is earlier. Hence, this approved program expired in 2005.

2. Program two:

Epsilor's expansion program of its existing enterprise in Dimona was granted the status of an "approved enterprise" under the Investments Law and was entitled to investments grants from the State of Israel in the amount of 24% on property and equipment located at its Dimona plant.

The approved expansion program is in the amount of approximately $600,000. Epsilor effectively operated the program during 2002, and is entitled to the tax benefits available under the Investments Law (commencing from 2003).

Taxable income derived from the approved enterprise is subject to a reduced tax rate during seven years beginning from the year in which taxable income is first earned (tax exemption for the first two-year period and 25% tax rate for the five remaining years).

Those benefits are limited to 12 years from the year that the enterprise began operations, or 14 years from the year in which the approval was granted, whichever is earlier. Hence, this approved program will expire in 2009.

3. Program three:

In U.S. dollars

NOTE 14:- INCOME TAXES (Cont.)

Epsilor's expansion program of its existing enterprise in Dimona was granted the status of an "approved enterprise" under the Investments Law, and is entitled to investments grants from the State of Israel in the amount of 32% on property and equipment located at its Dimona plant.

The approved expansion program is in the amount of approximately $945,000. This program has not yet received final approval.

Taxable income derived from the approved enterprise is subject to a reduced tax rate during seven years beginning from the year in which taxable income is first earned (tax exemption for the first two-year period and 25% tax rate for the five remaining years).

Those benefits are limited to 12 years from the year that the enterprise began operations, or 14 years from the year in which the approval was granted, whichever is earlier.

The main tax benefits available to Epsilor are:

a) Reduced tax rates:

As stated above for each specific program

b) Accelerated depreciation:

Epsilor is entitled to claim accelerated depreciation in respect of machinery and equipment used by the "Approved Enterprise" for the first five years of operation of these assets.

Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate of 34%.

If retained tax-exempt profits attributable to the "approved enterprise" are distributed, they would be taxed at the corporate tax rate applicable to such profits as if Epsilor had not elected the alternative system of benefits, currently 25% for an "approved enterprise."

Dividends paid from the profits of an approved enterprise are subject to tax at the rate of 15% in the hands of their recipient.

As of December 31, 2005 there are no tax exempt profits earned by Epsilor's "approved enterprises" by Israel law that will be distributed as a dividend and accordingly no deferred tax liability was recorded as of December 31, 2005. Furthermore, management has indicated that it has no intention of declaring any dividend.

On April 1, 2005, an amendment to the Investment Law came into effect ("the Amendment") and has significantly changed the provisions of the Investment Law. The Amendment limits the scope of enterprises which may be approved by the Investment Center by setting criteria for the approval of a facility as a Privileged Enterprise, such as provisions generally requiring that at least 25% of the Privileged Enterprise's income will be derived from export. Additionally, the Amendment enacted major changes in the manner in which tax benefits are awarded under the Investment Law so that companies no longer require Investment Center approval in order to qualify for tax benefits.

In U.S. dollars

NOTE 14:- INCOME TAXES (Cont.)

However, the Investment Law provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the law as they were on the date of such approval. Therefore, the existing Approved Enterprise of the Israeli subsidiary's will generally not be subject to the provisions of the Amendment. As a result of the Amendment, tax-exempt income generated under the provisions of the Amended Investment Law, will subject the Company to taxes upon distribution or liquidation and the Company may be required to record deferred tax liability with respect to such tax-exempt income. As of December 31, 2005, the Company did not generate income under the provision of the amended Investment Law.

c. Other tax information about the Israeli subsidiaries:

1. Measurement of results for tax purposes under the Income Tax Law (Inflationary Adjustments), 1985

Results for tax purposes are measured in real terms of earnings in NIS after certain adjustments for increases in the Consumer Price Index. As explained in Note 2.b., the financial statements are presented in U.S. dollars. The difference between the annual change in the Israeli consumer price index and in the NIS/dollar exchange rate causes a difference between taxable income and the income before taxes shown in the financial statements. In accordance with paragraph 9(f) of SFAS No. 109, EFL, Epsilor and MDT have not provided deferred income taxes on this difference between the reporting currency and the tax bases of assets and liabilities.

2. Tax benefits under the Law for the Encouragement of Industry (Taxation), 1969:

EFL and Epsilor are "industrial companies," as defined by this law and, as such, are entitled to certain tax benefits, mainly accelerated depreciation, as prescribed by regulations published under the inflationary adjustments law, the right to claim amortization of know-how, patents and certain other intangible property rights as deductions for tax purposes.

3. Tax rates applicable to income from other sources:

Income from sources other than the "Approved Enterprise," is taxed at the regular rate of 34%. See also Note 14.e.

4. Tax loss carryforwards:

As of December 31, 2005, EFL has operating and capital loss carryforwards for Israeli tax purposes of approximately $82 million, which are available, indefinitely, to offset future taxable income.

e. Tax rates applicable to the income of the Group companies:

Until December 31, 2003, the regular tax rate applicable to income of companies (which are not entitled to benefits due to "approved enterprise", as described above) was 36%. In June 2004, an amendment to the Income Tax Ordinance (No. 140 and Temporary Provision), 2004 was passed by the "Knesset" (Israeli parliament) and on July 25, 2005, another law was passed, the amendment to the Income Tax Ordinance (No. 147) 2005, according to which the corporate tax rate is to be progressively reduced to the following tax rates: 2004 - 35%, 2005 - 34%, 2006 - 31%, 2007 - 29%, 2008 - 27%, 2009 - 26%, 2010 and thereafter - 25%.

In U.S. dollars

NOTE 14:- INCOME TAXES (Cont.)

f. Deferred income taxes:

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and amounts used for income tax purposes. Significant components of the Company's deferred tax assets resulting from tax loss carryforward are as follows:

	December 31, 2005	December 31, 2004
Operating loss carryforward [1]	$ 32,326,283	$ 32,532,998
Reserve and allowance	2,222,333	1,328,479
Net deferred tax asset before valuation allowance	34,548,616	33,861,477
Valuation allowance	(34,483,796)	(33,725,995)
Total deferred tax asset	$ 64,820	$ 135,482
Deferred tax liability	$ -	$ 51,366

(1)

	December 31, 2005	December 31, 2004
Domestic	$ 8,981,133	$ 7,703,459
Foreign	23,345,150	24,829,539
	$ 32,326,283	$ 32,532,998

The Company and its subsidiaries provided valuation allowances in respect of deferred tax assets resulting from tax loss carryforwards and other temporary differences. Management currently believes that it is more likely than not that the deferred tax assets related to the loss carryforwards and other temporary differences will not be realized. The change in the valuation allowance as of December 31, 2005 was $757,801.

g. Loss from continuing operations before taxes on income and minorities interests in loss (earnings) of a subsidiary:

	Year ended December 31 2005	2004	2003
Domestic	$ 21,473,366	$ 8,006,205	$ 7,411,121
Foreign	2,269,522	405,305	1,697,617
	$ 23,742,888	$ 8,411,510	$ 9,108,738

In U.S. dollars

NOTE 14:- INCOME TAXES (Cont.)

h. Taxes on income were comprised of the following:

	Year ended December 31		
	2005	**2004**	**2003**
Current state and local taxes	$ 83,365	$ 539,674	$ 44,102
Deferred taxes	14,345	(37,857)	—
Taxes in respect of prior years	139,962	84,292	352,091
	$ 237,672	$ 586,109	$ 396,193
Domestic	$ 153,950	$ 163,087	$ 33,020
Foreign	83,722	423,022	363,173
	$ 237,672	$ 586,109	$ 396,193

i. A reconciliation between the theoretical tax expense, assuming all income is taxed at the statutory tax rate applicable to income of the Company and the actual tax expense as reported in the Statement of Operations is as follows:

	Year ended December 31,		
	2005	**2004**	**2003**
Loss from continuing operations before taxes, as reported in the consolidated statements of income	$ (23,742,888)	$ (8,411,510)	$ (9,108,738)
Statutory tax rate	34%	34%	34%
Theoretical income tax on the above amount at the U.S. statutory tax rate	$ (8,072,582)	$ (2,859,914)	$ (3,096,971)
Deferred taxes on losses for which valuation allowance was provided	1,611,971	556,692	1,146,754
Non-deductible expenses	5,669,144	1,629,874	1,873,129
State taxes	67,470	168,081	33,020
Accrual for deferred taxes on undistributed earnings	(49,328)	49,416	—
Foreign income in tax rates other then U.S rate	897,617	919,895	86,954
Taxes in respect of prior years	139,963	84,292	352,091
Others	(26,583)	37,773	1,216
Actual tax expense	$ 237,672	$ 586,109	$ 396,193

In U.S. dollars

NOTE 15:– SELECTED STATEMENTS OF OPERATIONS DATA

Financial income (expenses), net:

	Year ended December 31,		
	2005	2004	2003
Financial expenses:			
Interest, bank charges and fees	$ (1,473,799)	$ (622,638)	$ (355,111)
Amortization of compensation related to warrants issued to the holders of convertible debentures and beneficial conversion feature	(1,702,753)	(4,142,109)	(3,928,237)
Bonds premium amortization	(47,734)	(202,467)	—
Foreign currency translation differences	(54,840)	(71,891)	115,538
	(3,279,126)	(5,039,105)	(4,167,810)
Financial income:			
Interest	192,771	443,182	129,101
Realized gain from marketable securities sale	2,863	40,119	—
Financial income in connection with warrants granted (Note 12.d. and 13.f.3.)	377,803	326,839	—
Total	$ (2,705,689)	$ (4,228,965)	$ (4,038,709)

NOTE 16:– SEGMENT INFORMATION

a. General:

The Company and its subsidiaries operate primarily in three business segments (see Note 1.a. for a brief description of the Company's business) and follow the requirements of SFAS No. 131.

Prior to its purchase of FAAC, Epsilor and AoA, the Company had managed its business in two reportable segments organized on the basis of differences in its related products and services. With the acquisition of FAAC and Epsilor early in 2004 and AoA in August of 2004, the Company reorganized into three segments: Simulation and Training (formerly known as Simulation and Security); Armor; and Battery and Power Systems. As a result the Company restated information previously reported in order to comply with new segment reporting.

The Company's reportable operating segments have been determined in accordance with the Company's internal management structure, which is organized based on operating activities. The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies. The Company evaluates performance based upon two primary factors, one is the segment's operating income and the other is based on the segment's contribution to the Company's future strategic growth.

In U.S. dollars

NOTE 16:– SEGMENT INFORMATION (Cont.)

b. The following is information about reported segment gains, losses and assets:

	Simulation and Training	Armor	Battery and Power Systems	All Others(4)	Total
2005					
Revenues from outside customers	$ 26,805,772	$ 12,322,678	$ 9,916,145	$ —	$ 49,044,595
Depreciation , amortization and impairment expenses [(1)]	(1,645,057)	(14,043,019)	(909,463)	(229,626)	(16,827,165)
Direct expenses [(2)]	(21,967,755)	(13,955,199)	(9,757,402)	(7,752,865)	(53,433,221)
Segment net income (loss)	$ 3,192,960	$ (15,675,540)	$ (750,720)	$ (7,982,491)	(21,215,791)
Financial expenses (after deduction of minority interest)					(2,707,620)
Net loss from continuing operations					$ (23,923,411)
Segment assets [(3)] [(4)]	$ 32,741,946	$ 7,185,010	$ 12,040,415	$ 688,023	$ 52,655,394
2004					
Revenues from outside customers	$ 21,464,406	$ 17,988,687	$ 10,500,753	$ —	$ 49,953,846
Depreciation , amortization and impairment expenses [(1)]	(1,983,822)	(1,755,847)	(1,132,953)	(135,613)	(5,008,235)
Direct expenses [(2)]	(17,910,967)	(16,444,476)	(9,974,544)	(5,431,627)	(49,761,614)
Segment net income (loss)	$ 1,569,617	$ (211,636)	$ (606,744)	$ (5,567,240)	(4,816,003)
Financial expenses (after deduction of minority interest)					(4,226,310)
Net loss from continuing operations					$ (9,042,313)
Segment assets [(3)]	$ 1,872,943	$ 5,819,266	$ 3,455,188	$ 730,595	$ 11,877,992
2003					
Revenues from outside customers	$ 8,022,026	$ 3,435,716	$ 5,868,899	$ —	$ 17,326,641
Depreciation expenses and amortization	(757,997)	(169,668)	(527,775)	(139,630)	(1,595,070)
Direct expenses [(2)]	(7,308,649)	(3,584,284)	(5,945,948)	(4,200,770)	(21,039,651)
Segment net income (loss)	$ (44,620)	$ (318,236)	$ (604,824)	$ (4,340,400)	(5,308,080)
Financial expenses (after deduction of minority interest)					(4,039,951)
Net loss from continuing operations					$ (9,348,031)
Segment assets [(3)]	$ 898,271	$ 730,291	$ 2,128,062	$ 450,864	$ 4,207,488

(1) Includes depreciation of property and equipment, amortization expenses of intangible assets and impairment of goodwill and other intangible assets in the amount of $12,256,756 and $320,279 in the years 2005 and 2004, respectively.

(2) Including, *inter alia*, sales and marketing, general and administrative and tax expenses.

(3) Consisting of property and equipment, inventory and intangible assets.

(4) Out of those amounts, goodwill in the Company's Simulation and Training, Battery and Power Systems and Armor Divisions stood at $23,605,069, $4,968,675 and $985,413 as of December 31, 2005, respectively, and $22,845,372, $5,308,917 and $11,591,227 as of December 31, 2004, respectively.

In U.S. dollars

NOTE 16:– SEGMENT INFORMATION (Cont.)

c. Summary information about geographic areas:

The following presents total revenues according to end customers location for the years ended December 31, 2005, 2004 and 2003, and long-lived assets as of December 31, 2005, 2004 and 2003:

	2005		2004		2003	
	Total revenues	Long-lived assets	Total revenues	Long-lived assets	Total revenues	Long-lived assets
	U.S. dollars					
U.S.A.	$ 38,953,462	$ 32,840,172	$ 40,656,729	$ 45,154,086	$ 10,099,652	$ 6,778,050
Germany	188,635	—	319,110	—	2,836,725	—
England	931,008	—	344,261	—	29,095	—
Thailand	—	—	—	—	95,434	—
India	1,723,031	—	3,061,705	—	—	—
Israel	5,700,267	11,999,415	4,212,408	13,560,822	3,576,139	2,954,441
Other	1,548,192	—	1,359,633	—	689,596	—
	$ 49,044,595	$ 44,839,587	$ 49,953,846	$ 58,714,908	$ 17,326,641	$ 9,732,491

d. Revenues from major customers:

	Year ended December 31,		
	2005	2004	2003
	%		
Batteries and power systems:			
Customer A	7%	8%	27%
Armor:			
Customer B	5%	4%	17%
Customer C	9%	24%	—
Simulation and Training:			
Customer D	24%	13%	—
Customer E	—	1%	16%

e. Revenues from major products:

	Year ended December 31,		
	2005	2004	2003
Electric vehicle	$ 205,485	$ 232,394	$ 408,161
Water activated batteries	1,181,114	921,533	703,084
Military batteries	8,515,329	9,324,247	4,757,116
Car and aircraft armoring	12,322,679	17,988,686	3,435,715
Simulators	26,785,772	21,414,968	7,961,302
Other	34,216	72,018	61,263
Total	$ 49,044,595	$ 49,953,846	$ 17,326,641

NOTE 17:– SUBSEQUENT EVENTS

a. In March 2006, a dispute of approximately $517,000 related to the Company's former consumer cellphone battery and charger business between the Company and a major department store chain, in respect of which dispute the Company had made an accrual of $200,000 in the past, was settled for a single payment by the Company of $120,000 in cash. The Company's liability accrual was updated to reflect this settlement agreement.

In U.S. dollars

NOTE 17:– SUBSEQUENT EVENTS (UNAUDITED) (Cont.)

b. In March 2006, a dispute that began in 2005 involving a claim against the Company in the amount of approximately $1.1 million was settled for an aggregate payment by the Company of $90,000 in cash, $60,000 of which was payable in 2006 and $30,000 of which was payable in 2007. The Company accrued $90,000 to reflect this settlement agreement.

c. In February 2006, the Company and one of its existing warrant holders agreed to amend certain of the investor's existing warrants (consisting of 25,950 warrants to purchase common stock at a price of $30.80 per share and 322,455 warrants to purchase common stock at a price of $19.32 per share - a total of 348,405 warrants) to provide for an exercise price equal to $6.165, in exchange for (i) immediate exercise by the investor of all such warrants, with the exercise price being deposited in a collateral account to secure the Company's obligation to repay its 8% secured convertible debentures due in September 2006, and (ii) the issuance to the investor of 139,362 warrants, expiring on March 31, 2008, with an exercise price equal to $8.316 per share.

d. In March 2006, the Company and certain of its existing warrant holders ("Investors") agreed to amend certain of the Investors' existing warrants (consisting of 29,657 warrants to purchase common stock at a price of $30.80 per share, 56,991 warrants to purchase common stock at a price of $26.32 per share, 19,625 warrants to purchase common stock at a price of $20.30 per share, 8,929 warrants to purchase common stock at a price of $20.125 per share, and 178,761 warrants to purchase common stock at a price of $19.32 per share - a total of 293,963 warrants) to provide for an exercise price equal to $5.6, in exchange for (i) immediate exercise by the Investors of all such warrants, with the exercise price being deposited in a collateral account to secure the Company's obligation to repay its 8% secured convertible debentures due in September 2006, and (ii) the issuance to the Investors of a total of 117,585 warrants, expiring on March 31, 2008, with an exercise price equal to $8.316 per share.

e. See Note 13.h.

SUPPLEMENTARY FINANCIAL DATA

Quarterly Financial Data (unaudited) for the two years ended December 31, 2005

	Quarter Ended*			
2005	**March 31**	**June 30**	**September 30**	**December 31**
Net revenue	$ 10,387,445	$ 12,236,910	$ 11,189,675	$ 15,230,565
Gross profit	$ 4,015,570	$ 3,627,634	$ 2,756,392	$ 4,261,263
Net profit (loss) from continuing operations	$ (2,456,500)	$ (5,422,514)	$ (12,708,932)	$ (3,335,465)
Net profit (loss) from discontinued operations	$ —	$ (200,000)	$ —	$ 80,000
Net profit (loss) for the period	$ (2,456,500)	$ (5,622,514)	$ (12,708,932)	$ (3,255,465)
Deemed dividend to certain stockholders of common stock	$ —	$ —	$ —	$ —
Net loss attributable to common stockholders	$ (2,456,500)	$ (5,622,514)	$ (12,708,932)	$ (3,255,465)
Net profit (loss) per share - basic and diluted	$ (0.43)	$ (0.97)	$ (2.16)	$ (0.53)
Shares used in per share calculation	5,721,578	5,770,011	5,891,127	6,103,348

	Quarter Ended			
2004	**March 31**	**June 30**	**September 30**	**December 31**
Net revenue	$ 7,182,254	$ 9,928,248	$ 16,272,521	$ 16,570,823
Gross profit	$ 2,625,034	$ 3,353,501	$ 4,723,573	$ 5,240,644
Net profit (loss) from continuing operations	$ (2,517,889)	$ (4,396,123)	$ 1,126,845	$ (3,255,146)
Net loss from discontinued operations	$ —	$ —	$ —	$ —
Net profit (loss) for the period	$ (2,517,889)	$ (4,396,123)	$ 1,126,845	$ (3,255,146)
Deemed dividend to certain stockholders of common stock	$ (1,163,000)	$ —	$ (2,165,952)	$ —
Net loss attributable to common stockholders	$ (3,680,889)	$ (4,396,123)	$ (1,039,107)	$ (3,255,146)
Net profit (loss) per share - basic and diluted	$ (0.87)	$ (0.95)	$ (0.19)	$ (0.58)
Shares used in per share calculation	4,243,319	4,607,078	5,481,732	5,648,227

FINANCIAL STATEMENT SCHEDULE

Arotech Corporation and Subsidiaries

Schedule II – Valuation and Qualifying Accounts

For the Years Ended December 31, 2005, 2004 and 2003

Description	Balance at beginning of period	Additions charged to costs and expenses	Balance at end of period
Year ended December 31, 2005			
Allowance for doubtful accounts	$ 55,394	$ 120,786	$ 176,180
Allowance for slow moving inventory	217,672	1,062,336	1,280,008
Valuation allowance for deferred taxes	33,725,995	757,801	34,483,796
Totals	$ 33,999,061	$ 1,940,923	$ 35,939,984
Year ended December 31, 2004			
Allowance for doubtful accounts	$ 61,282	$ (5,888)	$ 55,394
Allowance for slow moving inventory	96,350	121,322	217,672
Valuation allowance for deferred taxes	34,801,887	(1,075,892)	33,725,995
Totals	$ 34,959,519	$ (960,458)	$ 33,999,061
Year ended December 31, 2003			
Allowance for doubtful accounts	$ 40,636	$ 20,646	$ 61,282
Allowance for slow moving inventory	—	96,350	96,350
Valuation allowance for deferred taxes	29,560,322	5,241,565	34,801,887
Totals	$ 29,600,958	$ 5,358,561	$ 34,959,519

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this amended report:

(1) Financial Statements - See Index to Financial Statements on page 2 above.
(2) Financial Statements Schedules - Schedule II - Valuation and Qualifying Accounts. All schedules other than those listed above are omitted because of the absence of conditions under which they are required or because the required information is presented in the financial statements or related notes thereto.
(3) Exhibits - The following Exhibits are filed herewith:

Exhibit No.	Description
23.1	Consent of Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global
23.2	Consent of Stark Winter Schenkein & Co., LLP
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this amended report to be signed on its behalf by the undersigned, thereunto duly authorized, on July 24, 2006.

AROTECH CORPORATION

By: /s/ Robert S. Ehrlich

Name: Robert S. Ehrlich
Title: Chairman and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this amended report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Robert S. Ehrlich Robert S. Ehrlich	Chairman Chief Executive Officer and Director (Principal Executive Officer)	July 24, 2006
/s/ Thomas J. Paup Thomas J. Paup	Vice President - Finance (Principal Financial Officer)	July 24, 2006
/s/ Danny Waldner Danny Waldner	Controller (Principal Accounting Officer)	July 24, 2006
/s/ Steven Esses Steven Esses	President, Chief Operating Officer and Director	July 24, 2006
/s/ Jay M. Eastman Dr. Jay M. Eastman	Director	July 24, 2006
/s/ Lawrence M. Miller Lawrence M. Miller	Director	July 24, 2006
/s/ Jack E. Rosenfeld Jack E. Rosenfeld	Director	July 24, 2006
/s/ Edward J. Borey Edward J. Borey	Director	July 24, 2006
/s/ Seymour Jones Seymour Jones	Director	July 24, 2006

EXHIBIT INDEX

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32.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit 23.1

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in the Registration Statements on Form S-8 (Nos. 333-74197, 333-86728 and 333-124960) (pertaining to the 1995 Amended and Restated Non-Employee Director Stock Option Plan, the 1998 Non-Executive Employee Stock Option and Restricted Stock Purchase Plan and the 2004 Stock Option and Restricted Stock Purchase Plan) and Form S-3 (Nos. 333-95361, 333-33986, 333-37630, 333-45818, 333-49628, 333-59346, 333-63514, 333-99559, 333-99673, 333-106420, 333-110729, 333-112611, 333-124959, 333-124961, 333-128497 and 333-129713) of our report dated March 30, 2006, except for the final paragraph, as to which the date is June 15, 2006 and for Note 13.h., as to which the date is July 24, 2006, with respect to the consolidated financial statements and schedule of Arotech Corporation, and of our report dated June 15, 2006 with respect to Arotech management's assessment of the effectiveness of internal control over financial reporting, and the effectiveness of internal control over financial reporting of Arotech, included in this Form 10-K/A.

/s/ Kost, Forer, Gabbay & Kasierer

Kost, Forer, Gabbay & Kasierer
A Member of Ernst & Young Global

Tel-Aviv, Israel
July 24, 2006

Exhibit 23.2

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in the Registration Statements on Form S-8 (Nos. 333-74197, 333-86728 and 333-124960) (pertaining to the 1995 Amended and Restated Non-Employee Director Stock Option Plan, the 1998 Non-Executive Employee Stock Option and Restricted Stock Purchase Plan and the 2004 Stock Option and Restricted Stock Purchase Plan) and Form S-3 (Nos. 333-95361, 333-33986, 333-37630, 333-45818, 333-49628, 333-59346, 333-63514, 333-99559, 333-99673, 333-106420, 333-110729, 333-112611, 333-124959, 333-124961, 333-128497 and 333-129713) of our reports dated January 31, 2006 with respect to the financial statements of Armour of America, Inc. and March 10, 2006 with respect to the financial statements of IES Interactive Training, Inc. for the year ended December 31, 2005 referred to in Arotech Corporation's Annual Report on Form 10-K/A for the year ended December 31, 2005.

/s/ Stark Winter Schenkein & Co., LLP

STARK WINTER SCHENKEIN& CO., LLP

Denver, Colorado
July 24, 2006

Exhibit 31.1

CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Robert S. Ehrlich, certify that:

1. I have reviewed this annual report on Form 10-K/A of Arotech Corporation;

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

(b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this annual report based on such evaluation (the "Evaluation Date"); and

(d) disclosed in this annual report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of this annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: July 24, 2006

/s/ Robert S. Ehrlich

Robert S. Ehrlich, Chairman and CEO
(Principal Executive Officer)

Exhibit 31.1

CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Thomas J. Paup, certify that:

1. I have reviewed this amended annual report on Form 10-K/A of Arotech Corporation;

2. Based on my knowledge, this amended annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this amended annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this amended annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this amended annual report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this amended annual report is being prepared;

(b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this amended annual report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this amended annual report based on such evaluation (the "Evaluation Date"); and

(d) disclosed in this amended annual report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of this amended annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: July 24, 2006

/s/ Thomas J. Paup

Thomas J. Paup, Vice President - Finance and CFO
(Principal Financial Officer)

Exhibit 31.2

CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Thomas J. Paup, certify that:

1. I have reviewed this amended annual report on Form 10-K/A of Arotech Corporation;

2. Based on my knowledge, this amended annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this amended annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this amended annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this amended annual report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this amended annual report is being prepared;

(b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this amended annual report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this amended annual report based on such evaluation (the "Evaluation Date"); and

(d) disclosed in this amended annual report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of this amended annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: July 24, 2006

/s/ Thomas J. Paup

Thomas J. Paup, Vice President - Finance and CFO
(Principal Financial Officer)

Exhibit 32.1

**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the amended Annual Report of Arotech Corporation (the "Company") on Form 10-K/A for the year ended December 31, 2005 filed with the Securities and Exchange Commission (the "Report"), I, Robert S. Ehrlich, Chairman and Chief Executive Officer of the Company, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, hereby certify that the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

By: /s/ Robert S. Ehrlich

Robert S. Ehrlich
Chairman and CEO
(Chief Executive Officer)

Date: July 24, 2006

Exhibit 32.2

**CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the amended Annual Report of Arotech Corporation (the "Company") on Form 10-K/A for the year ended December 31, 2005 filed with the Securities and Exchange Commission (the "Report"), I, Thomas J. Paup, Vice President - Finance and Chief Financial Officer of the Company, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, hereby certify that the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

By: /s/ Thomas J. Paup

Thomas J. Paup,
Vice President - Finance and CFO
(Chief Financial Officer)

Date: July 24, 2006